

UNCITRAL

Practice Guide to the Model Law on Secured Transactions



UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW

UNCITRAL
Practice Guide to
the Model Law on
Secured Transactions



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Decision by the United Nations Commission on International Trade Law adopting the UNCITRAL Practice Guide to the UNCITRAL Model Law on Secured Transactions

The United Nations Commission on International Trade Law,

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

Recalling also General Assembly resolutions 56/81 of 12 December 2001, 63/121 of 11 December 2008, 65/23 of 6 December 2010 and 68/108 of 16 December 2013, in which the Assembly recommended that States consider or continue to consider becoming parties to the United Nations Convention on the Assignment of Receivables in International Trade (New York, 2001)¹ and give favourable consideration to the UNCITRAL Legislative Guide on Secured Transactions (2007),² the UNCITRAL Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property (2010)³ and the UNCITRAL Guide on the Implementation of a Security Rights Registry (2013),⁴ respectively,

Recalling further General Assembly resolution 71/136 of 13 December 2016, in which the Assembly recommended that States give favourable consideration to the UNCITRAL Model Law on Secured Transactions (2016)⁵ and that, at its fiftieth session, in 2017, the Commission adopted the UNCITRAL Model Law on Secured Transactions: Guide to Enactment (2017)⁶ for the benefit of States when revising or adopting legislation relevant to secured transactions,

¹General Assembly resolution 56/81, annex.

²United Nations publication, Sales No. E.09.V.12.

³United Nations publication, Sales No. E.11.V.6.

⁴United Nations publication, Sales No. E.14.V.6.

⁵United Nations publication, Sales No. E.17.V.1.

⁶*Official Records of the General Assembly, Seventy-second Session, Supplement No. 17 (A/72/17)*, para. 216.

Recognizing that an efficient secured transactions regime with a publicly accessible security rights registry of the kind provided for in the Model Law is likely to increase access to affordable secured credit and thus promote economic growth, sustainable development, the rule of law and financial inclusion, as well as assist in combating poverty,

Noting that at its fiftieth session, in 2017, the Commission decided that Working Group VI (Security Interests) should prepare a draft practice guide to the Model Law on Secured Transactions,⁷ and that at its fifty-first session, in 2018, the Commission requested the Working Group to complete the work expeditiously, with a view to presenting a final draft to the Commission for consideration at its fifty-second session, in 2019,⁸

Noting also that Working Group VI devoted three sessions, in 2017 and 2018, to the preparation of the draft practice guide,⁹ and that, at its thirty-fourth session, in 2018, the Working Group adopted parts of the draft practice guide and agreed that the Secretariat would be tasked with and should be given flexibility in preparing the final draft,¹⁰

Noting with satisfaction that the draft practice guide provides guidance to parties involved in secured transactions as well as other relevant parties in States that have enacted the Model Law on Secured Transactions, by describing the types of secured transactions that creditors and other businesses can undertake under the Model Law and providing step-by-step explanations on how to engage in the most common and commercially important transactions,

Expressing its appreciation to international intergovernmental and non-governmental organizations active in the reform of secured transactions law for their participation in and support for the development of the Model Law on Secured Transactions, the Guide to Enactment and the draft practice guide,

Expressing further its appreciation to experts and practitioners in the area of secured transactions who have contributed their expertise to the Secretariat in preparing and revising the draft Practice Guide,

Having considered the draft practice guide at its fifty-second session, in 2019,

⁷ Ibid., paras. 227 and 449; *Official Records of the General Assembly, Seventy-third Session, Supplement No. 17 (A/73/17)*, para. 161.

⁸ Ibid., *Seventy-third Session, Supplement No. 17 (A/73/17)*, para. 163.

⁹ For the reports of those sessions of the Working Group, see A/CN.9/932, A/CN.9/938 and A/CN.9/967.

¹⁰ A/CN.9/967, paras. 11 and 79.

1. *Adopts* the Practice Guide to the UNCITRAL Model Law on Secured Transactions, consisting of the text contained in document A/CN.9/993 with amendments adopted by the Commission at its fifty-second session,¹¹ and authorizes the Secretariat to make the necessary consequential revisions;

2. *Requests* the Secretary-General to publish the Practice Guide, including electronically and in the six official languages of the United Nations, and to disseminate it broadly to Governments and other interested bodies;

3. *Recommends* that all States give favourable consideration to the Model Law when revising or adopting legislation relevant to secured transactions, taking also into account the information in the Guide to Enactment, and invites States that have used the Model Law to advise the Commission accordingly; and

4. *Also recommends* that the Practice Guide be made broadly available and that States consider undertaking capacity-building efforts based on the Practice Guide to assist parties in transactions enabled and facilitated by the Model Law.

¹¹ Official Records of the General Assembly, Seventy-fourth Session, Supplement No. 17 (A/74/17), paras. 78-98.

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I. Introduction

A. Purpose of the Guide

1. What the Guide is about

1. This Guide provides practical guidance to parties involved in secured transactions in States that enact the UNCITRAL Model Law on Secured Transactions (2016) (the “Model Law” or “ML”). This Guide:

- Explains key features and benefits of the Model Law
- Illustrates the types of secured transactions that can be undertaken under the Model Law, and
- Provides step-by-step explanations of how to engage in the most common and commercially important secured transactions.

2. Who the Guide is for

2. This Guide is for readers who wish to understand transactions governed by, and in many cases made possible by, the Model Law. This chapter provides a summary of the key benefits of the Model Law and things to bear in mind as readers go through the contents of the Guide. Chapter II provides guidance mainly to creditors and debtors (as well as their advisers) on how to engage in several common types of secured transactions. It also provides guidance to others whose rights may be affected by a secured transaction (for example, a buyer of an asset subject to a security right, a judgment creditor of a debtor and a grantor’s insolvency representative). Chapter III is intended primarily for regulated financial institutions and prudential regulatory authorities.

3. This Guide is also useful to other stakeholders, such as policymakers and legislators of States considering whether to adopt the Model Law as well as judges and arbitrators.

B. Key features and benefits of the Model Law

1. *Greater access to credit at a reasonable cost*

4. For many businesses, movable assets are the main types of asset that they can offer as collateral. The Model Law makes it easy to use most types of movable assets as collateral. This means that legislative reform based on the Model Law makes it easier for businesses, particularly small and medium-sized enterprises, to access credit. Such reform can also reduce the cost of credit and make it possible for businesses to obtain credit for longer periods. Readily available credit at a reasonable cost helps businesses grow and prosper. This has a positive impact on the economic prosperity of a State as a whole.

2. *What is a “security right”*

5. A “security right” under the Model Law is a property right in a movable asset that secures an obligation owed by a person (the “debtor”) to another person (the “secured creditor”). A secured creditor can protect itself when the debtor does not pay by applying the value of the asset (the “encumbered asset” or the “collateral”) to recover what it is owed. A secured creditor generally has priority over an unsecured creditor, including in insolvency proceedings.

6. The obligation secured by a security right is likely to be the payment of money by the debtor. However, a security right can also secure a non-monetary obligation, such as the obligation to perform services under a contract.

7. In most cases, the debtor will be the person who grants the security right (the “grantor”). However, a person can also grant a security right in its assets to secure the obligation of another person.

3. *A comprehensive secured transactions regime*

8. Some legal systems allow a person to grant a security right in movable assets only to a limited extent or only in a very restrictive way. Even where a legal system allows movable assets to be used as collateral, the rules are often complex or unclear. In some States, a range of mechanisms have been developed to enable creditors to rely on security over movable assets. However, this has often resulted in overlapping and fragmented secured transactions regimes.

9. In contrast, the Model Law allows a person to grant a security right in:
- Almost any type of movable asset, including inventory, equipment, receivables, bank accounts and intellectual property
 - An asset that it already owns, as well as an asset that it may acquire in the future, and
 - All of its movable assets, both present and future.

4. A functional and unitary approach to secured transactions

10. The Model Law applies to all transactions under which a property right in a movable asset is created by agreement to secure payment or other performance of an obligation, regardless of the form of transaction, the terms used by the parties to describe the transaction or whether the assets are owned by the grantor or the secured creditor. This means that the Model Law applies not only to transactions in which the grantor grants a security right in an asset that it already owns, but also to transactions that take the form of the creditor retaining title to an asset to secure performance of an obligation, for example, retention-of-title sales and financial leases. Those transactions are all regarded as creating a security right under the Model Law and are therefore subject to the same treatment. This is a major distinction from traditional positions in many legal systems, under which some or all of these transactions would be treated differently.

5. A simple way to create a security right

11. It is easy to create a security right under the Model Law. The parties only need to enter into a security agreement that satisfies the simple requirements of the Model Law. Unlike some secured transactions regimes, registration is not a requirement for the creation of a security right under the Model Law. The Model Law also allows a person to grant a security right in an asset without having to give possession of the asset to the secured creditor.

12. A security right created in this way in an asset is effective against the grantor and extends to identifiable proceeds of the asset. For example, if an encumbered asset is sold, the security right will automatically extend to what is received as a result of the sale unless otherwise agreed by the parties.

6. *A simple and transparent registration system*

13. A secured creditor will want to make sure that its security right is also effective against third parties, as the security right will otherwise not be of much benefit. The most usual way of making a security right effective against third parties under the Model Law is to register a “notice” in the general security rights registry (the “Registry”). The Registry under the Model Law should be fully electronic and accessible online for registering a notice and for carrying out searches.

14. The registration process as set out in the Model Registry Provisions (“MRP”) of the Model Law is straightforward. Secured creditors do not need to submit the security agreement or any other documents. Registrations can be made at any time, even before the parties enter into a security agreement.

15. Registration of a notice in the Registry has the following consequences:

- It makes the security right effective against third parties
- It allows the secured creditor to establish the priority of its security right over rights of competing claimants, and
- Third parties can find out about the potential existence of a security right in a movable asset by searching the Registry.

7. *Flexibility given to the parties*

16. The Model Law provides a great deal of flexibility to parties in structuring the transaction to reflect the outcome that they want to achieve. It also provides flexibility to a secured creditor in enforcing its security right, including by allowing it to enforce the security right itself without having to go to court.

C. Some things to bear in mind

1. The Guide is about using movable assets as collateral for secured financing

17. This Guide provides an introduction to good practices for the use of movable assets as collateral to secure obligations and for transactions involving the outright transfer of receivables. In particular, it focuses on how these transactions can be effectively entered into and administered.

18. This Guide does not deal with transactions using immovable property (for example, land or buildings) as collateral, as those transactions are not covered by the Model Law. This Guide also does not deal with movable assets that are excluded from the scope of the Model Law (for example, intermediated securities).

19. This Guide is also not a general manual on financing. Guidance on good financing practices is provided only when the financing involves the use of movable assets as security.

2. Terminology used in the Guide

20. The Model Law relies on a number of specific and carefully worded definitions. The Glossary in annex II provides an explanation and examples of some of the key terms used in this Guide. However, readers should always rely on the precise language of the Model Law as enacted in the State to structure their transaction and to understand how the law will apply.

3. The Guide does not address everything in the Model Law

21. This Guide explains transactions governed by the Model Law in a general and non-legalistic way without going into every detail of the Model Law. Readers should bear this in mind, including when using the sample documents provided in the annexes.

4. The Model Law has options

22. Some articles of the Model Law contain options for enacting States to choose in their legislation. This Guide provides guidance on each of the different options. Readers should determine which option has been chosen by the enacting State and use this Guide accordingly.

5. The Model Law interacts with other laws

23. The Model Law does not operate in a vacuum. Other laws, such as contract law, property law, intellectual property law, negotiable instruments law, consumer protection law, insolvency law, banking law, and civil procedure law will influence how the Model Law operates in the enacting State. International treaties and

conventions applicable in the enacting State may also be relevant. Readers should determine how these other laws may affect transactions under the Model Law.

24. In some cases, the Model Law contemplates this interaction. For example, it provides that the steps that a judgment creditor needs to take to acquire rights in an encumbered asset may be set out in other laws of the enacting State (ML art. 37(1)). Even when not expressly contemplated by the Model Law, other laws may still apply. These laws may not be specific to secured transactions. For example, rules of contract law that set out what parties need to do to enter into a binding contract will generally apply to security agreements.

25. There may be other laws that restrict the applicability of the Model Law. For example, a law may limit the ability of certain types of parties to enter into a security agreement or may impose limitations on enforcement against certain types of assets. The law of some States may also provide for the reduction of the scope of assets that can be encumbered if their value substantially exceeds the amount of the secured obligation (often referred to as a restriction on “over-collateralization”, see UNCITRAL Legislative Guide on Secured Transactions, chapter II, paras. 68–69). Readers should check whether the laws of the enacting State impose any such limitations.

D. Secured transactions involving microenterprises

26. The Model Law is designed to improve access to credit and to lower the cost of credit for all kinds of businesses. It is particularly well suited for small and medium-sized enterprises, which are the most common form of businesses in most States. The Model Law enables secured lending to microenterprises, which might have had only limited access to credit under prior law because mechanisms suitable to secure loans to microenterprises were not readily available or because the related cost was too high.

An individual, Ms. X, wants to borrow money to start a business selling food on the street. Ms. X only has household items such as her cooking equipment to offer as collateral. Lender Y provides Ms. X with a three-month loan secured by these household items. Ms. X uses the loan to purchase supplies for her business. Ms. X decides to call her business “Home Cooking”. After three months, Home Cooking is successfully established, and Ms. X can repay the loan. Ms. X then applies to Lender Y for a larger loan. Lender Y provides the loan, this time secured by supplies purchased by Ms. X for the business and money made by Ms. X from the sale of the food

27. The above is an example of secured financing of a microenterprise. It illustrates certain features that are typical of many microenterprises and of their secured financing. The amount of the loan is likely to be very small. Ms. X is an individual and her business is not incorporated, so the loan is made to Ms. X personally, even though the business operates under the trading name “Home Cooking”. There is little distinction between the business and the individual who owns and runs the business, or between the business assets and the household assets that are provided as security.

28. As is typical for many microenterprises, Ms. X does not need to register her business in a public registry, which means that information about the legal or financial status of the business and the name and address of the individual who operates the business are unlikely to be publicly available. Even when Home Cooking is well established, Ms. X may not have kept accounting records that Lender Y could look at to understand the cash flows. It is also likely that the income and expenditures of the business have been mixed up with those of Ms. X.

29. These features present Lender Y with some challenges when it assesses whether and how to extend secured credit to Ms. X. The lack of formal financial information (including from credit bureaus) and public registration of the business may affect the type of due diligence that Lender Y needs to undertake. When registering a notice in the Registry, Lender Y should use the name of Ms. X and not the trading name “Home Cooking”. Lender Y should also closely monitor the business of Ms. X during the period of the loan, so that it becomes aware of any changes in name, address, legal status, location of the assets or other matters which could adversely affect Lender Y’s security right, including the ability to enforce it.

30. As a more general point, Lender Y should bear in mind that its ability to create or enforce its security right may be limited by other laws of the enacting State, such as laws that restrict the creation of security rights in household goods or the seizure of personal assets, or laws that limit the amount for which a security right in those assets can be enforced.

II. How to engage in secured transactions under the Model Law

31. This chapter is addressed mainly to parties who engage in secured transactions. It describes how to carry out a number of common or important types of secured transactions under the Model Law. This chapter will also be useful for others that might be affected by a secured transaction, such as a potential buyer of an encumbered asset, other creditors of a grantor and a grantor's insolvency representative.

32. The transactions described in this chapter are by no means the only types of transactions that are possible under the Model Law. For example, transactions described in this chapter may be combined to develop a wide range of secured financing products. In this way, the Model Law facilitates supply chain financing and value chain arrangements, as well as more complex financing arrangements such as syndicated lending and securitization.

A. How to take an effective security right

33. Under the Model Law, there are only two requirements that must be satisfied to create a security right in a movable asset that is effective against the grantor:

- The asset to be encumbered must be one in which the grantor can grant a security right, and
- There must be a security agreement between the grantor and the secured creditor.

34. A security right that is effective only against the grantor, however, has little practical value, and the secured creditor should take steps to make the security right effective against third parties. The secured creditor does not need to take possession of the encumbered asset in order to make the security right effective against the grantor and third parties. This means that the decision on which party has possession of the encumbered asset is largely a business one.

Example 1: Company X has a printing business and wants to borrow money from Bank Y. Bank Y is willing to make the loan if it can take security over Company X's printing press. However, Company X needs to keep possession of the printing press, so that it can continue to operate its business.

Example 2: Designer X wants to borrow money from Bank Y to start her own business. Designer X does not yet have any business assets to provide as security but does own some antique jewellery. Bank Y is willing to make the loan if it can take security over the jewellery.

1. *Can the grantor grant a security right in the asset*

35. To grant a security right, the grantor needs to have rights in the asset to be encumbered or the power to encumber it (ML art. 6(1) and (2)). In most cases, the grantor will be the owner of the asset, which will be enough to enable it to grant a security right in that asset.

36. A person with a limited right in an asset is able to grant a security right in that limited right even though that person is not the owner of the asset. For instance, if Company X in example 1 is leasing the printing press under a short-term lease agreement, it can grant a security right in its right to use the printing press under the lease agreement, but not in the printing press itself. Company X's limited right in the printing press limits the value of the collateral offered by Company X and Bank Y should take care to assess that value before entering into the transaction.

37. A person can also grant a security right in an asset when it has the power to encumber it. For example, a person may be authorized by the owner of an asset to create a security right in that asset in favour of a secured creditor.

2. *What are the requirements for a security agreement*

Transactions in which the secured creditor does not take possession of the encumbered asset

38. In example 1, to obtain a security right in the printing press, Bank Y needs to enter into an agreement with Company X that creates a security right in Bank Y's favour (the "security agreement"). It is not necessary for Bank Y to take possession of the asset, and the printing press can stay in the possession of Company X so that Company X can keep using it. This is commonly referred to as a non-possessory security right.

39. The Model Law sets out some minimum requirements for a security agreement (ML art. 6(3)). The security agreement needs to:

- Be in writing and signed by Company X
- Identify the parties (Bank Y as the secured creditor and Company X as the grantor)
- Describe the obligation that is secured, and
- Describe the encumbered asset (the printing press) in a way that reasonably identifies it.

40. Some enacting States may also require the security agreement to state the maximum amount for which the security right may be enforced (ML art. 6(3)(d)).

Transactions in which the secured creditor takes possession of the encumbered asset

41. In example 2, Bank Y can enter into a written security agreement with Designer X to obtain a security right in the jewellery. However, if Bank Y takes possession of the jewellery, the security agreement can be oral and does not need to be in writing (ML art. 6(4)). This is commonly referred to as a pledge or possessory security right. Nevertheless, it will be prudent to put the security agreement in writing to avoid later disputes over its terms and in case Bank Y later returns the jewellery to Designer X.

3. What must the secured creditor do for its security right to be effective against third parties

Non-possessory security right

42. A security right that is created in the printing press as mentioned above will be effective against Company X. However, Bank Y will want to ensure that its security right is also effective against third parties. Otherwise, Bank Y will not be protected if Company X becomes insolvent, or if Company X sells the printing press or grants a security right in it to another creditor.

43. The most usual way in which Bank Y can make its security right in the printing press effective against third parties is to register a notice in the Registry (on how to register a notice, see part II.E). Third parties can then find out about the potential existence of Bank Y's security right in the printing press by searching the Registry.

Possessory security right

44. In example 2, Bank Y can also register a notice in the Registry that describes the jewellery. If Bank Y instead takes possession of the jewellery, it does not need to register a notice to make its security right effective against third parties (ML art. 18(2)). As noted above, a written security agreement is also not necessary.

45. However, it will be prudent for Bank Y to take these steps anyway, since having a written security agreement and a notice registered in the Registry means that Bank Y's security right will remain effective against the grantor and third parties should it later give up possession of the jewellery.

4. Whose obligation can be secured

Can a security right secure an obligation owed by a person other than the grantor?

46. The grantor is usually the person who owes the secured obligation. However, the Model Law allows a person to grant a security right in its assets to secure an obligation that is owed by another person. For instance, in example 1, Company X could grant a security right over the printing press to secure a loan made by Bank Y to Company Z.

47. This type of arrangement is common when financing is provided to a group of companies (see example 7). In such a case, each company in the group will grant a security right in its assets to secure the obligations of all other members of the group. Another example of such an arrangement is when a family member provides its assets to secure a loan made to another member of the family. However, these types of arrangements may be limited or prohibited by other laws of the enacting State.

5. Can a security right be created in more than one asset of the grantor and in future assets

Security over more than one asset of the grantor

Example 3: Company X operates a conference management business and owns a number of high-quality projectors. It wants to borrow money from Bank Y. Bank Y is willing to make the loan if it can take security over all of Company X's projectors.

48. The Model Law allows a secured creditor to take security over more than one asset of the grantor at the same time (ML art. 8). As in example 1, Bank Y simply needs to ensure that the description of the encumbered assets in the security agreement and in the notice covers all of Company X's projectors, rather than just a single projector. This can be done by describing the projectors in a generic manner (for example, "all projectors") or listing all of the projectors individually (for example, by listing the respective manufacturer and serial number) (ML art. 9, see section II.E.5).

Security over future assets

Example 4: Farmer X farms beef cattle and wants to borrow money from Bank Y to purchase feed. Bank Y is willing to make the loan if it can take security over Farmer X's cattle, including cattle that Farmer X purchases in the future.

49. The Model Law allows a grantor to grant a security right not only in assets that the grantor already has, but also in assets which do not yet exist or in which the grantor does not yet have rights at the time the security agreement is entered into (ML art. 6(2), for the definition of "future asset", see ML art. 2(n)).

50. In example 4, to take security over the cattle, Bank Y simply needs to take the same steps as in example 1. The only difference is that Bank Y needs to describe the encumbered assets, in both the security agreement and the notice, in a way that includes any cattle that Farmer X may purchase in the future, for example, with a phrase such as "all cattle, both present and future". By doing this:

- Bank Y obtains a security right in all cattle already owned by Farmer X when the security agreement is entered into, and
- Bank Y will obtain a security right in any additional cattle as they are purchased by Farmer X in the future.

51. Bank Y does not need to enter into a separate security agreement or to register another notice when Farmer X purchases additional cattle, as Bank Y will automatically have security over new cattle as they are purchased by Farmer X.

Security over all movable assets (an all-asset security right)

Example 5: Travel Agency X organizes jungle safaris and plans to expand its offering to include white-water rafting expeditions. It wants to borrow money from Bank Y to cover the expansion costs. Bank Y is willing to make the loan if it can take security over all of Travel Agency X's assets, including future assets.

52. Taking security over all of a grantor's movable assets, both present and future, is no more difficult than taking security over a single existing asset. Bank Y simply needs to take the same steps as in previous examples. The only difference is that Bank Y must describe the encumbered assets, in both the security agreement and the notice, in a way that encompasses all the assets, for example, with a phrase such as "all movable assets, both present and future". In example 5, this will give Bank Y a security right not only in all of Travel Agency X's movable assets at the time the security agreement is entered into, but also in all movable assets that Travel Agency X acquires in the future.

53. Depending on the type of assets that Travel Agency X has, Bank Y may need to take additional steps to ensure that its security right in those assets has priority. This would be the case if the assets include shares (see example 7), bank accounts (see examples 8A and 8B), negotiable instruments (see example 9) or intellectual property (see example 12).

54. If Travel Agency X is not able to repay the loan, Bank Y can enforce its security right by disposing of the assets separately, or by disposing of all of them together. In either case, Bank Y needs to undertake the disposition in accordance with the enforcement provisions of the Model Law (on how to enforce a security right, see part II.I). The fact that Bank Y is able to dispose of all the assets together may make it easier for Bank Y to sell the business of Travel Agency X in its entirety, if this is possible under other laws of the enacting State.

6. Common types of secured transactions

Financing the acquisition of tangible assets

Example 6: Company X wants to purchase drilling equipment from Vendor Y.

Example 6A (Vendor retention-of-title finance): Rather than Company X paying the price on delivery, Vendor Y is willing to give 30-day credit terms to Company X. Vendor Y's terms of sale state that it retains title to the drilling equipment until Company X has paid the purchase price in full.

Example 6B (Vendor purchase loan finance): Vendor Y is prepared to give 30-day credit terms to Company X, if Company X grants Vendor Y a security right in the drilling equipment for the unpaid purchase price.

Example 6C (Bank purchase loan finance): Vendor Y has an arrangement with Bank Z to help its customers with financing. Company X finances the purchase of the drilling equipment with a loan from Bank Z. Bank Z is willing to

make the loan if Company X grants a security right in the drilling equipment. The proceeds of Bank Z's loan to Company X are used to pay Vendor Y.

Example 6D (Vendor lease finance): Vendor Y agrees to lease the drilling equipment to Company X for a three-year period. The rental payments owed by Company X over the term of the lease are sufficient to cover Vendor Y's capital investment in the drilling equipment and its cost of funding the lease. At the end of the lease term, Company X can purchase the drilling equipment for a nominal sum.

55. Example 6 involves situations where a security right is created under the Model Law, even though only examples 6B and 6C expressly refer to Company X granting a security right in the drilling equipment. This is because the Model Law covers all transactions in which a property right in a movable asset is used to serve a security function, regardless of the form of the transaction or who has title (see sections I.B.2 and I.B.4). The choice of form is based on business considerations and the type of person providing the financing.

56. In examples 6A and 6B, Vendor Y provides short-term credit for the purchase. In example 6A, Vendor Y retains title to the drilling equipment to secure the unpaid purchase price, because the sale agreement states that Company X does not become the owner of the drilling equipment until the purchase price is paid. Retention of ownership is a common security mechanism in many traditional legal systems. The Model Law, however, looks to the underlying commercial objectives of the transaction and recognizes that the retention of title by Vendor Y is meant to secure Company X's payment of the purchase price. Vendor Y is therefore regarded as having a security right in the drilling equipment, and the retention-of-title sale agreement is regarded as a security agreement.

57. Vendor Y thus needs to meet the requirements of the Model Law to have an effective security right in the drilling equipment. If the sale agreement describes the drilling equipment in a way that reasonably identifies it, is signed by Company X, and satisfies the other requirements for a security agreement, then Vendor Y will have a security right in the drilling equipment that is effective against Company X. To make its security right effective against third parties, Vendor Y needs to register a notice in the Registry.

58. The retention of title in example 6A will not give Vendor Y any greater protection than the security right Vendor Y obtains respectively in examples 6B and 6C, because the Model Law regards the retention-of-title sale as creating a security right. If Company X defaults in example 6A, Vendor Y cannot simply take the drilling equipment back. It must enforce its security right in the equipment in

accordance with the enforcement provisions of the Model Law (see part II.I). If Vendor Y disposes of the equipment for an amount exceeding what is owed by Company X, Vendor Y must return the surplus to Company X.

59. In example 6B, Vendor Y is selling the drilling equipment to Company X on short-term credit. This is in effect a short-term loan of the purchase price by Vendor Y, the payment of which is secured by Vendor Y's security right in the drilling equipment. Vendor Y needs to follow the same steps as in example 6A to obtain an effective security right.

60. In examples 6C and 6D, Company X is obtaining long-term financing to acquire the drilling equipment. The Model Law applies in the same way as in examples 6A and 6B. In example 6D, while the transaction is set up as a lease, the lessor (Vendor Y) is relying on its ownership of the drilling equipment to secure Company X's rental payment obligations under the lease. As in example 6A, Vendor Y is therefore regarded as having a security right in the drilling equipment, and the lease agreement is regarded as a security agreement. If the lease agreement describes the drilling equipment in a way that reasonably identifies it, is signed by Company X, and satisfies the other requirements for a security agreement, then Vendor Y will have a security right in the drilling equipment that is effective against Company X. To make its security right effective against third parties, Vendor Y needs to register a notice in the Registry.

61. While the lease financing in example 6D is provided by the seller of the drilling equipment, lease finance can also be provided by third-party financiers. Where that is the case, the financier will buy the drilling equipment from the vendor, and then lease it to Company X.

62. The security rights in examples 6A to 6D are all "acquisition security rights" under the Model Law because Vendor Y or Bank Z is taking security over the drilling equipment to secure credit extended to enable Company X to acquire the equipment (for the definition, see ML art. 2(b)). If Vendor Y or Bank Z complies with article 38 of the Model Law, its security right in the drilling equipment will have priority over security rights of non-acquisition secured creditors, even if they previously registered a notice covering future assets of the kind subject to the acquisition security right (see section II.G.3). This is an important exception to the first-to-register rule of the Model Law, which provides that priority between competing secured creditors is usually determined by the order in which they register the notices (see section II.G.1).

Security over a company's shares

Example 7: A manufacturing business is operated through a group of private wholly-owned companies. Mr. X owns all the shares in Company A, the holding company of the group. Company A owns all the shares in three subsidiaries, Companies B, C and D. The shares are represented by certificates. Company A wants to borrow money to expand the operations of the group. Bank Y is willing to make the loan if it can take security over all of the assets of all the companies in the group.

63. For Bank Y to take security over all of the assets of all the companies of the group, it will need to obtain an all-asset security right from Company A (including all of its shares in Companies B, C and D) in the same way as in example 5. It will also need to obtain an all-asset security right from Companies B, C and D in the same manner.

64. In example 7, the borrower is Company A. As Companies B, C and D are not borrowers, Bank Y may require each of them to guarantee the payment obligation of Company A (subject to other laws of the enacting State that may limit the use of guarantees in these circumstances). If Companies B, C and D provide guarantees, the security right granted by each company will usually secure their obligations under the guarantee.

65. To strengthen its position further, Bank Y can require as a condition for its financing that Mr. X grant a security right in his shares in Company A. This would give Bank Y an additional enforcement option, because it can then sell the group in its entirety (by selling the shares in Company A). This is likely to be simpler than Bank Y selling the group's assets separately.

66. Bank Y can make each of its security rights effective against third parties by registering notices in the Registry identifying each of Company A, Company B, Company C, Company D and Mr. X as a grantor. Bank Y can also make its security rights over the shares in each of the companies effective against third parties by taking possession of the certificates. The advantage of taking possession is that Bank Y will have priority over any competing security right created by the same grantor that is made effective against third parties by registration, even if the other secured creditor registered its notice before Bank Y took possession (ML art. 51(1)).

67. Shares in privately-held corporate groups may not always be represented by certificates. If this were the case in example 7, Bank Y would not be able to make its security right in the shares effective against third parties by taking possession.

Bank Y could instead make its security right in the uncertificated shares effective against third parties by doing one of the following:

- Bank Y could arrange for its security right to be recorded in the shareholder register maintained by each company or arrange for itself to be recorded in each shareholder register as the holder of the shares (ML art. 27(a)), or
- Bank Y could enter into a control agreement with each issuer of the shares and the grantor (ML art. 27(b)). For example with respect to the shares of Company B, the control agreement would be between Bank Y (secured creditor), Company B (issuer) and Company A (holder of the shares and grantor). The control agreement would require Company B to follow Bank Y's instructions with respect to the shares without requiring any further consent from Company A (ML art. 2(g)(i)).

68. Similar to taking possession of certificated shares, the above-mentioned methods of achieving third-party effectiveness of a security right in uncertificated shares ensure priority over a competing security right that is made effective against third parties by registration (ML art. 51(2) and (3)).

69. The Model Law applies to example 7 because the shares in the example are “non-intermediated securities” (for the definition, see ML art. 2(w) and (ii)). The Model Law does not apply, however, to security rights in “intermediated securities” (ML art. 1(3)(c), securities that are credited to a securities account with an intermediary). If a secured creditor wants to take security over intermediated securities, it will need to rely on other laws of the enacting State.

Security over bank accounts

Example 8A: Company X needs a loan to cover operating expenses. Its main assets are a printing press and funds in its bank account with Bank Y. Bank Z is willing to make a loan if it can take security over Company X's printing press. However, Bank Z also wants to take security over the bank account with Bank Y, to protect itself against the risk that the printing press might unexpectedly depreciate in value.

70. Like any other movable asset, it is possible to obtain a security right in a bank account (described in the Model Law as obtaining a security right in “a right to payment of funds credited to a bank account”). Taking an effective security right in a bank account is no more difficult than taking security over a printing press or any other type of asset. As in example 1, Bank Z simply needs to enter into a

security agreement and register a notice that both describe the printing press and the bank account in a way that reasonably identifies them as the encumbered assets. The bank account can be described by identifying the bank where Company X maintains its account and stating the account number. Alternatively, a phrase such as “all bank accounts, both present and future” can be used. This would give Bank Z security over all of Company X’s bank accounts, even those that Bank Z was unaware of at the time it made the loan.

71. However, as the bank account is maintained at another bank, Bank Z may want to make its security right in the bank account effective against third parties by entering into a control agreement (ML art. 25(b), for the definition, see ML art. 2(g)(ii)). This is a three-party agreement between Company X, Bank Y and Bank Z, which provides that Bank Y will follow the instructions of Bank Z with respect to the payment of funds from the account without requiring any further consent from Company X. A control agreement would give Bank Z’s security right priority over competing security rights in the bank account that were made effective against third parties only by registering a notice (ML art. 47(3)).

72. A control agreement needs to state that Bank Z can instruct Bank Y to transfer the funds directly to it if Company X defaults. It will also often provide Bank Z with additional protection, for example, by limiting Company X’s ability to withdraw funds from the account. If Bank Y is unwilling to agree to terms that Bank Z considers important, Bank Z can say that it will make the loan only if Company X moves its funds to Bank Z or to another bank that will agree to those terms.

73. If Bank Z wants to take security over all of Company X’s present and future bank accounts, it will not be practically possible to enter into a control agreement with all potentially relevant banks. This means that Bank Z’s security right in any unknown or future bank accounts of Company X can only be made effective against third parties by registering a notice in the Registry.

Example 8B: In example 8A, Bank Y, instead of Bank Z, is willing to make the loan if it can take security over Company X’s printing press and the bank account.

74. In the same way as in example 8A, Bank Y can obtain a security right in Company X’s bank account and make it effective against third parties by describing the bank account in the security agreement and in the notice. As Company X has the bank account with Bank Y, Bank Y’s security right in the bank account will, however, be automatically effective against third parties without the need to describe it in the notice (ML art. 25(a)). This means that the notice only needs to describe the printing press.

75. Because the bank account is with Bank Y, Bank Y's security right in the bank account will generally have priority over any competing security right in that bank account, unless the other secured creditor becomes the holder of the account (ML art. 47(2)).

Security over negotiable instruments

Example 9: Company X is owed a large sum of money by Company Y. Company Y issues a negotiable instrument to Company X under which it promises to pay the money to Company X in instalments over a five-year period. Company X needs a loan to pay operating expenses and wants to use the negotiable instrument to secure the loan. Bank Z is willing to make the loan on that basis.

76. In example 9, Bank Z can take security over the negotiable instrument by entering into a security agreement that describes the encumbered asset, for example, as "a negotiable instrument signed by Company Y on DD/MM/YYYY, payable to Company X, in the amount of (the face amount stated in the instrument)".

77. If Company X regularly receives negotiable instruments as payment in the course of its business and is willing to give Bank Z a security right in all of them, Bank Z can take security over all of Company X's existing and after-acquired negotiable instruments by entering into a security agreement that describes the encumbered assets as "all negotiable instruments in favour of Company X, both present and future".

78. As in other examples, Bank Z can make its security right effective against third parties by registering a notice using the same description as in the security agreement. However, Bank Z should also consider making its security right effective against third parties by taking possession of the negotiable instrument, either in addition to or in lieu of registering a notice. One advantage is that Bank Z, by taking possession, will have priority over any competing security right that was made effective against third parties by registration, even if the notice was registered before Bank Z took possession (ML art. 46(1)). Another advantage is that Bank Z will be protected against a buyer or other consensual transferee of the encumbered negotiable instrument (ML art. 46(2)).

Outright transfer of receivables

Example 10: Company X is in the business of selling commercial refrigerators to customers. Because the cost of refrigerators is quite high, Company X often agrees to allow customers to pay over time rather than on delivery. This creates a pool of receivables, which is Company X's most valuable asset. Company X needs cash before the receivables are due so that it can pay its suppliers and cover other operating expenses. Factor Y agrees to provide Company X with cash by purchasing the receivables.

79. Businesses often raise funds for their operations with the receivables that they generate, rather than waiting for the receivables to be paid. Sometimes they borrow money from a financier with the receivables serving as security for their obligations. Sometimes they transfer ownership of the receivables to a financier outright, usually at a discount. The latter type of a financier is often referred to as a “factor”.

80. The Model Law applies not only to security rights in receivables that secure an obligation, but also to outright transfers of receivables (ML art. 1(2)). Under the Model Law, the transferor of a receivable is treated as a grantor, the transferee as a secured creditor, and the agreement between them as a security agreement.

81. One reason why the Model Law applies to outright transfers of receivables is that it is often difficult to tell whether a person is transferring receivables outright or granting a security right in them. Applying the provisions of the Model Law to both types of transactions reduces the need to make this distinction. Another benefit of this approach is that it allows the provisions of the Model Law to determine priority among all competing rights in the same receivable, including the rights of an outright transferee.

82. As in other examples, Factor Y in example 10 needs to enter into an agreement with Company X that satisfies the requirements of a security agreement. Factor Y will also need to register a notice in the Registry to make its ownership of the receivables effective against third parties.

83. An outright transfer of receivables can affect the debtors of the receivables (for instance, the customers of Company X that have not yet paid in example 10). Factor Y should take into account the provisions of the Model Law that deal with the protection of the debtors of the receivables (ML arts. 61–67). As a general rule, the transfer of receivables does not affect the rights and obligations of the debtors of the receivable unless they have been notified of the transfer. Even after notification, a debtor of a receivable may be able to raise against Factor Y any defences and rights of set-off arising from the debtor's underlying contract with

Company X or from any other contract with Company X that was part of the same transaction (ML art. 64(1)).

84. Factor Y should also be aware that the enforcement provisions of the Model Law (ML arts. 72–82) do not apply to outright transfers of receivables. This is because there is no obligation that is secured.

85. In transactions involving an outright transfer of receivables, all economic benefits and risks are transferred to the factor. If more is collected from the receivables than what the factor paid for them, the factor retains the benefit. Similarly, if there are receivables that cannot be collected, the loss is borne by the factor, unless agreed otherwise (which is referred to as “recourse factoring”).

Inventory and receivables financing

Example 11: Company X sells kitchen appliances to restaurant owners. Restaurant owners are given 60 days to pay for the appliances. Company X does not take security over the kitchen appliances to secure the unpaid purchase price. While waiting for payment from the restaurant owners, Company X needs money to acquire inventory and cover operating expenses.

Aware of Company X’s business cycle, Bank Y is willing to provide Company X with a line of credit or a revolving loan, under which Company X can draw down a loan when it needs money to buy inventory or pay other expenses. Payments made by the restaurant owners are used to repay the line of credit. This type of arrangement helps Company X to avoid borrowing more than it needs and keeps its financing costs down. Borrowings and repayments can be frequent, and the outstanding loan amount can constantly fluctuate.

Bank Y takes security over all of Company X’s existing and future inventory and receivables. Bank Y also takes security over Company X’s bank account with Bank Y, into which Company X deposits the payments it receives from the restaurant owners. The pool of encumbered assets constantly fluctuates, as inventory is acquired and converted into receivables, the receivables are collected, and new inventory is acquired.

86. Taking security over all existing and future inventory and receivables is no more difficult than taking security over a piece of equipment. Bank Y simply needs to enter into a security agreement and register a notice describing the encumbered assets, for example as “all inventory and receivables, both present and future”. To obtain an effective security right in the bank account, Bank Y needs to take the same steps as in example 8B.

87. As in example 10, Bank Y should take into account the provisions of the Model Law that deal with the protection of the debtors of the receivables (ML arts. 61–67). Restaurant owners in example 11 may have defences or rights of set-off against Company X, which could reduce the value of the receivables. As a way to manage this risk, Bank Y can ask Company X to require the restaurant owners to agree not to raise any defences or rights of set-off (ML art. 65).

Security over intellectual property

Example 12: Company X is a textile manufacturer that needs a loan. It holds patents to protect its inventions in the fabrics, trademarks under which it markets its products, and copyrights in its advertising materials. Company X also holds a licence to use a patented production method in manufacturing its products. Bank Y is willing to make the loan if it can take security over all Company X's present and future intellectual property rights (including intellectual property licences).

88. The Model Law applies to security rights in intellectual property to the extent that its rules are not inconsistent with the enacting State's intellectual property laws (ML art. 1(3)(b)). The following assumes that there is no inconsistency.

89. Bank Y can take security over all Company X's present and future intellectual property rights and intellectual property licences and make its security right effective against third parties by entering into a security agreement and registering a notice in the same way as in previous examples. The security agreement and the notice can describe the encumbered assets as "all intellectual property and rights as licensee of intellectual property, both present and future".

90. Bank Y should be aware that its security right in the intellectual property does not extend to tangible assets with respect to which the intellectual property is used (ML art. 17). For example, Bank Y's security right in Company X's trademarks will not extend to any textile products manufactured by Company X that bear those trademarks. If Bank Y wants to take security over those products, it will need to add them to the description of encumbered assets in both the security agreement and the notice.

7. Proceeds, products and commingling

Security right extending to proceeds

Example 13: Company X obtains a loan from Bank Y. It grants Bank Y a security right in its printing press to secure the loan. Bank Y registers a notice in the Registry. Company X later sells the printing press to Company Z. Company X receives a cheque from Company Z in payment.

91. Bank Y's security right in the printing press automatically extends to the cheque received by Company X from Company Z. This is because a security right in an encumbered asset extends to its identifiable proceeds (ML art. 10). "Proceeds" are defined broadly in the Model Law as any asset in any form that is derived from, or received in respect of, the original encumbered asset (for the definition, see ML art. 2(bb)).

92. The cheque received by Company X is only one example of proceeds. If the printing press were damaged or destroyed by fire, Bank Y's security right would extend to any insurance claim made by Company X. If the printing press were leased to Company Z, Bank Y's security right would extend to the rent received by Company X under the lease agreement. The same would apply if the printing press were exchanged for another item of equipment.

93. The broad notion of proceeds under the Model Law also includes "proceeds of proceeds". For example, if Company X uses the cheque that it received from Company Z to purchase a new copying machine, the copying machine would also be proceeds and Bank Y's security right would automatically extend to the copying machine.

94. A security right in proceeds is effective against the grantor as soon as the proceeds arise. However, a secured creditor may have to take additional steps to make its security right in the proceeds effective against third parties. This will depend on what type of asset the proceeds are.

95. If the proceeds are money, receivables, negotiable instruments or funds in a bank account, Bank Y does not need to take any additional steps to make its security right in the proceeds effective against third parties (ML art. 19(1)). In example 13, as Bank Y registered a notice describing the printing press as the encumbered asset, its security right in the cheque received by Company X is automatically effective against third parties (on the basis that a cheque is either a receivable or a negotiable instrument in the enacting State). The result would be the

same if Company X deposited the cheque into its bank account. However, Bank Y's security right in Company X's bank account is fragile as the deposited amount typically would be commingled with other funds in the bank account. In that case, Bank Y's security right in the bank account is limited to the deposited amount and terminates if the balance of the bank account later falls below the amount of the balance immediately before the funds were deposited (ML art. 10(2)). Even if Bank Y retains its security right in the bank account, its priority is subordinate to a security right granted in favour of the depository bank or in favour of a secured creditor who enters into a control agreement with the depository bank (see examples 8A and 8B).

96. If the proceeds are any other type of asset, Bank Y's security right in the proceeds will initially be effective against third parties for a short period after the proceeds arise without the need for Bank Y to take any steps (ML art. 19(2) (a)). However, it will only continue to be effective against third parties if Bank Y separately makes it effective against third parties before the expiry of that period (ML art. 19(2)(b)). Bank Y can register a notice after the expiry of that period, but the third-party effectiveness of its security right in the proceeds will have lapsed and will only be re-established as of the date of the new registration.

97. If Company X purchased a copying machine with the cheque that it received from Company Z, Bank Y will need to register a notice adding the description of the copying machine before the expiry of the time period to preserve the third-party effectiveness of its security right (see section II.E.8 and example 18). Another way for Bank Y to ensure that its security right in the copying machine is effective against third parties is to include a description of the potential proceeds in the security agreement and in the notice (for example, describing the encumbered asset as "all present and future equipment"). This would make the copying machine an original encumbered asset, not just proceeds.

98. In addition to Bank Y's security right in the printing press extending to the cheque from Company Z as proceeds, Bank Y's security right in the printing press will generally continue even after the printing press is sold to Company Z (ML art. 34(1), see section II.G.2 and example 22). If so, Bank Y can pursue its security right in both the printing press (now owned by Company Z) and the cheque received by Company X. However, Bank Y cannot use its security right in both assets to recover more than what it is owed by Company X (ML art. 79(2)).

Security right in tangible assets commingled in a mass or made into a product

Example 14A: Bank Y has a security right in 100,000 litres of oil that are later commingled with 50,000 litres of oil in the same tank, forming a mass of 150,000 litres of oil.

Example 14B: Bank Y has a security right in a gold bar worth 10,000 ¥, which is used to make a number of rings worth 30,000 ¥.

99. A security right in a tangible asset that is commingled with other assets of the same kind in a mass, or that is made into a product, extends to the mass or product (ML art. 11(1)). Bank Y's security right therefore extends to the 150,000 litres of oil in example 14A, and to the rings worth 30,000 ¥ in example 14B.

100. If Bank Y had made its security right in the 100,000 litres of oil or the gold bar effective against third parties before the oil was commingled in the tank or the gold bar was made into the rings, its security right is effective against third parties even after the commingling, without the need for Bank Y to take any further action (ML art. 20).

101. The extent to which a security right extends to a mass or a product is, however, limited. When an encumbered tangible asset is commingled in a mass, the security right extending to the mass is limited to the same proportion of the mass as the quantity of the tangible asset bore to the quantity of the entire mass immediately after the commingling (ML art. 11(2)). In example 14A, Bank Y's security right is therefore limited to two-thirds of the oil in the tank. If the overall quantity in the tank decreases to 75,000 litres, Bank Y will have security over two-thirds of the oil in the tank (50,000 litres), regardless of any increase or decrease in the value of the oil.

102. When an encumbered tangible asset is made into a product, the security right extending to the product is limited by reference to the value of the encumbered asset immediately before it became part of the product (ML art. 11(3)). In example 14B, Bank Y's security right in the rings is therefore limited to 10,000 ¥.

B. A key preliminary step for secured financing – due diligence

1. General

Examining and verifying facts

103. As described in part A, the Model Law makes it easy to enter into a wide range of secured transactions. While the legal requirements are straightforward, a

secured creditor should also examine and verify a number of facts before entering into a secured financing arrangement. These preliminary steps are referred to in this Guide as “due diligence”. The Model Law does not oblige a secured creditor to conduct due diligence, though it will be prudent to do so. Other laws, however, may require due diligence with respect to certain types of transactions, particularly those involving regulated financial institutions (see chapter III).

104. This part provides guidance on how to conduct due diligence when engaging in secured transactions under the Model Law. It does not address due diligence in relation to unsecured lending or lending in general.

Conducting the appropriate level of due diligence

105. Due diligence helps a secured creditor to assess whether the debtor will be able to repay the loan, and whether the potential value of the encumbered assets will be sufficient to secure the loan. Due diligence can also help a secured creditor to uncover potential risks in the transaction, so that it can deal with those risks in advance.

106. The appropriate level of due diligence for a particular transaction will depend on a number of factors, including who the grantor is, the type of secured transaction, and the type of assets to be encumbered. The level of due diligence will also have an impact on the cost of financing.

Using third parties for due diligence

107. A secured creditor can use third parties to assist with its due diligence. For example, a secured creditor can use a credit bureau to assess the creditworthiness of a grantor, or it may consult an industry analyst to develop an understanding of the strengths and weaknesses of the industry in which the grantor operates. A secured creditor may also use experts to inspect the grantor’s premises, books and records, or appraisers to assess the value of the assets over which it will be taking security.

Using a questionnaire as a starting point for due diligence

108. A secured creditor will often begin its due diligence by asking the grantor a series of questions. An example of such a “questionnaire”, sometimes referred

to as a “checklist” or “certificate”, is found in annex III (Sample Diligence Questionnaire). The Sample Diligence Questionnaire asks for information relating to a relatively complex secured transaction. It will need to be modified, sometimes simplified, to reflect the circumstances of each particular transaction. Once the grantor has filled out the questionnaire, the secured creditor should take appropriate steps to verify the correctness of the information that the grantor has provided.

Need for continued monitoring

109. This part focuses on the preliminary steps that should be taken by a secured creditor before entering into a transaction. However, a secured creditor should continue to monitor the status of the grantor and of the encumbered assets throughout the entire duration of the transaction (see part II.F).

2. Due diligence on the grantor

110. Due diligence on the grantor is an important step before engaging in any secured transaction. As part of its due diligence, a secured creditor should ask the grantor to provide important information about itself that is relevant to the transaction, including its creditworthiness. Some of this information will be relevant regardless of whether the financing is secured or not (for example, the risk of insolvency), while some will be particularly important in the context of a secured transaction.

111. For example, a secured creditor should obtain the correct name of the grantor (section 1 of the Sample Diligence Questionnaire), as using the correct name is critical when registering a notice (on what constitutes the correct name, see section II.E.5). A notice registered using an incorrect name will not make the security right effective against third parties. A secured creditor should also obtain any previous names of the grantor (section 1(f) and (g) of the Sample Diligence Questionnaire, see sections II.C.4 and II.E.8 as well as example 17).

112. Due diligence on the grantor may also involve examining whether there are other laws that limit or restrict the creation of a security right by the grantor or restrict the enforcement of a security right against the grantor or its assets to be encumbered (for example, consumer protection laws, see ML art. 1(5)).

3. *Due diligence on the assets to be encumbered*

113. A secured creditor should first identify which assets of the grantor it intends to take security over. Once the assets have been identified, the secured creditor should determine what it needs to do to obtain an effective security right in those assets. For example, where a security right is to be created in all of the grantor's present and future assets, the secured creditor should identify the different types of assets and determine what steps it needs to take with respect to each type, including the steps needed to obtain priority (see section II.A.5 and example 5).

114. A secured creditor should also ask the grantor to provide information on the assets to be encumbered (section 3 of the Sample Diligence Questionnaire). This information can then be used to do the following:

- Confirm the existence and location of the assets
- Verify whether the grantor has rights in the assets that allow it to grant a security right in the asset
- Determine the potential value of the assets
- Determine whether the assets are adequately insured, and
- Determine whether there are any third parties with rights in the assets that may potentially be in competition with the rights of the secured creditor ("competing claimants", for the definition, see ML art. 2(e)).

Confirming the existence and location of the assets

115. A secured creditor should confirm that the assets to be encumbered actually exist and where they are located. There are many ways in which this can be done. For example, the existence of inventory and equipment can be confirmed by a physical inspection. To conduct a physical inspection, a secured creditor will first need to ask for information about the location of the assets (sections 2(b) and 3 of the Sample Diligence Questionnaire). In the case of receivables, a secured creditor, with the consent of the grantor, can contact some of the debtors of the receivables to verify the amount owing. In the case of intellectual property registered in specialized registries, a secured creditor can examine the documents on file in the relevant registry to confirm whether the intellectual property rights exist, and to what extent.

116. Unlike present assets, it is not possible to confirm the existence of future assets and a secured creditor taking security over future assets may need to take a different approach. For example, with respect to future receivables, a secured creditor can review any existing long-term contracts under which receivables might arise in the future or review the past business practices of the grantor to form a view on what future receivables may be generated and when.

Verifying whether the grantor can grant a security right in the assets

117. To create an effective security right in an asset, the grantor must have rights in the asset or the power to encumber it (ML art. 6(1), see section II.A.1). If the grantor is the owner of the asset, it will be able to grant a security right in it. If the grantor is leasing an asset under a short-term lease agreement, it will be able to grant a security right in its right to use the asset. There may also be instances where the grantor, after it sold a receivable it owned, still has the power to grant a security right in the same receivable to another person (for example, if the transferee of the receivable did not meet the requirements to make its right in the receivable effective against third parties).

118. A secured creditor should assess whether the grantor can grant a security right in each of the assets to be encumbered. This is often done as part of the process for confirming the existence of the assets. In practice, to reduce cost, a secured creditor will often conduct a verification of a representative sample of the grantor's assets rather than every asset, particularly when taking security over all assets of the grantor.

119. Depending on the type of asset, a secured creditor can rely on a number of sources to verify that the grantor may grant a security right in the asset. In the case of equipment or inventory, for example, a secured creditor can examine the purchase orders issued by the grantor to the suppliers as well as the invoices issued by the suppliers. In the case of a bank account, a secured creditor can rely on the name and address of the deposit-taking bank, account information provided by the grantor, and bank statements. In the case of intellectual property registered in a specialized registry, the secured creditor can check whether the grantor is identified as the title holder in that registry. For intellectual property licences, the secured creditor can examine the licence contract.

120. With regard to receivables, the debtor of a receivable may include a term in the contract giving rise to the receivable to the effect that the payee (owner of the receivable) is not allowed to transfer the receivable, or to grant a security right in the receivable. Such a term is often referred to as an "anti-assignment clause". The Model Law, however, allows the owner of a receivable to transfer, or grant a security

right in, the receivable despite an anti-assignment clause (ML art. 13(1)). For instance, even if an anti-assignment clause was included in the contract between Company X and a restaurant owner in example 11 (see section II.A.6), this would not prevent Company X from granting, and Bank Y from obtaining, a security right in the receivable. Company X may be liable to compensate the restaurant owner for any damage caused by the breach of the anti-assignment clause, but the restaurant owner would not be able to avoid its obligations under the contract or avoid the security agreement solely because of the breach, or raise against Bank Y any claim it may have against Company X as a result of the breach (ML art. 13(2)).

Determining the potential value of the assets

121. There are many ways for a secured creditor to determine the value of the assets to be encumbered. The valuation method will differ depending on the type of asset. For example, if the asset is artwork, a secured creditor will need to first confirm that the work is authentic and then determine its value in the art market. If the asset is inventory, its value will normally be based on prices in the secondary market. If the assets are receivables, their value will usually be based on the amount which the secured creditor would expect to collect from the debtors of the receivables.

122. When determining the value of the assets, a secured creditor should also consider the manner and circumstances in which it is likely to enforce its security right (see part II.I). If it is likely that the secured creditor will dispose of the asset, its value should be based on prices in the relevant secondary market. A secured creditor should bear in mind, however, that it may not be able to recover the current market value as the realisable value may be affected by deteriorating market conditions. Furthermore, when a secured creditor is forced to dispose of the encumbered asset urgently, a buyer will expect to acquire the asset at a substantially lower price.

123. Some valuation methods can be costly relative to the value of the asset. In some cases, it may be difficult to determine the value of an asset, particularly if it is a type that is not regularly traded (for example, intellectual property).

124. In example 11 in section II.A.6, Bank Y provides Company X with a revolving loan, under which Company X can draw down a loan when it needs money to buy inventory or pay other expenses. Bank Y also takes security over all of Company X's existing and future inventory and receivables. The amount that Bank Y is prepared to lend under the revolving loan will typically depend on Bank Y's valuation of Company X's inventory and receivables. Bank Y's valuation of the inventory will take into account the stage in which the assets are in the

manufacturing process. Raw materials and finished products are typically more marketable and are valued higher than assets that are only partly complete. Bank Y's valuation of the receivables will take into account the payment history and creditworthiness of the restaurant owners, and whether the receivables owed by any of the restaurant owners represent a disproportionately high percentage of the receivables as a whole.

Determining whether the assets are adequately insured

125. As a security right in an encumbered asset extends to its identifiable proceeds (see section II.A.7), a secured creditor will have a security right in any insurance proceeds if the encumbered asset is damaged, stolen or destroyed. While there is no requirement in the Model Law that an encumbered asset must be insured, a secured creditor should generally make sure that the asset is adequately insured against loss or damage (section 10 of the Sample Diligence Questionnaire). For certain types of assets, however, insurance may not be readily available or the cost of insurance may be uneconomical.

126. A secured creditor should make sure that the amount for which the encumbered asset is insured is an accurate reflection of the value of the asset. It should also ensure that the terms of the insurance policy provide that any insurance proceeds are to be paid directly to the secured creditor or that the secured creditor is the beneficiary of the insurance policy.

Determining whether there are any potential competing claimants in the assets and the priority of the security right

127. As part of due diligence, a secured creditor should examine whether there are any potential competing claimants with a security right or other claim in the assets to be encumbered. The secured creditor should also assess the priority of its security right in relation to the rights of those competing claimants under the priority rules of the Model Law (see part II.G).

a. Search the Registry

128. A secured creditor can determine whether there may be competing security rights in the assets to be encumbered by searching the Registry using the name of the grantor (on how to search, see section II.C.3). The Registry will provide information about the potential existence of competing security rights in the assets to be encumbered that have been made effective against third parties by registration. The priority of the security right in relation to any competing security rights that

are disclosed by the search will usually be determined by the first-to-register rule (ML art. 29(a) and see section II.G.1). In addition to searching the Registry using the name of the grantor, a secured creditor should also conduct a search using the name of any previous owner of the asset to be encumbered (see section II.C.4).

- b. Determine whether a competing security right has been made effective against third parties by means other than registering a notice in the Registry

129. Even if a search of the Registry does not disclose any prior-registered notices, a secured creditor should check whether another secured creditor has made its security right effective against third parties by some other method provided in the Model Law.

130. For example, if the assets to be encumbered are tangible assets, a secured creditor should verify that the grantor is in physical possession of the asset and ensure that the grantor remains in possession until the secured creditor has registered a notice in the Registry. The reason is that obtaining possession is another means by which a secured creditor can make its security right effective against third parties (ML art. 18(2), see section II.A.3). If another secured creditor took possession of the asset before the registration of the notice, that secured creditor would generally have priority (ML art. 29(c)).

131. If the asset to be encumbered is a bank account, a secured creditor should inquire whether the deposit-taking bank has a security right in the account, and whether another secured creditor has entered into a control agreement with the deposit-taking bank and the grantor (see examples 8A and 8B). However, the deposit-taking bank is usually not obliged to disclose whether it has a security right in a bank account or whether it has entered into a control agreement with another secured creditor (ML art. 69(1)(b)). The secured creditor should therefore ask the grantor to direct the deposit-taking bank to provide this information.

132. Some enacting States may require ownership and security rights in certain types of assets to be registered in a specialized registry (ML art. 1(3)(e), see section II.E.12). If the assets to be encumbered are subject to a specialized registration regime, a secured creditor should conduct a search of the asset-specific registry to check whether there are any competing security rights in the assets (see section II.C.5).

- c. Determine whether the assets are proceeds of another asset

133. A secured creditor should determine whether the assets to be encumbered are proceeds of another asset and if so, whether that other asset is subject to a

security right. This is because a security right in that other asset may extend to the assets to be encumbered as its identifiable proceeds (see section II.A.7).

- d. Determine the existence of preferential claims and judgment creditors

134. A secured creditor should also determine whether there are any potential competing claimants with preferential claims (sections 8 and 9 of the Sample Diligence Questionnaire, see section II.G.5) and whether there are any existing or potential judgment creditors (section 6 of the Sample Diligence Questionnaire, see section II.G.6), as their existence may have an impact on the priority of its security right.

4. *Measures to take when there are competing claimants, in particular higher-ranking competing claimants*

Decide not to take security over the assets or not to proceed with the transaction

135. If a secured creditor determines that there are competing claimants with rights in the assets to be encumbered, particularly those that will have priority over it (referred to in this Guide as “higher-ranking” competing claimants), the secured creditor can decide not to take security over those assets, or perhaps decide not to proceed with the transaction at all.

Take other measures

136. Depending on the circumstances, there are other measures that a secured creditor can take when there are higher-ranking competing claimants.

- The secured creditor can change the terms of the loan agreement to reflect the additional risk (for example, by reducing the amount of the loan or increasing the interest rate).
- The secured creditor can ask the grantor to provide a different asset as security.
- If there is a higher-ranking secured creditor, the secured creditor can ask the higher-ranking secured creditor to subordinate the priority of its security right, for example, by entering into a subordination agreement.
- If there is a higher-ranking secured creditor, the secured creditor can ask the grantor to pay the obligation secured by the higher-ranking security

right or advance funds to the grantor to do so. Payment of the obligation will usually extinguish the security right of the higher-ranking secured creditor (ML art. 12, see part II.H). When the security right has been extinguished, the secured creditor can ask the grantor to request the higher-ranking secured creditor to register a cancellation notice if it does not do so voluntarily (see section II.E.10).

- If the description of the assets in the security agreement with the higher-ranking secured creditor was too broad and should not have included the assets to be encumbered, the secured creditor can ask the grantor to have the security agreement with the higher-ranking secured creditor amended to release the assets. When the security agreement has been amended, the secured creditor can ask the grantor to request the higher-ranking secured creditor to register an amendment notice to reflect this change if it does not do so voluntarily (see section II.E.10).
- If the assets to be encumbered were described in a registered notice but not in the security agreement, the secured creditor can ask the grantor to request the higher-ranking secured creditor to register an amendment notice removing the assets from the registered notice if it does not do so voluntarily (see section II.E.10).

Determine the residual value of the assets after they are used to discharge the obligations secured by higher-ranking security rights and other higher-ranking claims

137. Even if there are higher-ranking competing claimants, a secured creditor may still be prepared to take security over the assets. In that case, the secured creditor will need to assess the residual value of the assets after they are used to satisfy the obligations secured by any higher-ranking security right or other higher-ranking claims. The secured creditor should also manage the risk that a higher-ranking secured creditor may advance further credit which would be secured by its higher-ranking security right, as this could reduce the residual value of the assets (ML art. 44(1)).

138. An enacting State may require that a security agreement state the maximum amount for which the security right can be enforced (ML art. 6(3)(d)) and that the same information be included in the notice (MRP art. 8(e)). In such a State, if the residual value of the assets is greater than the maximum amount stated in the agreement with, and in the notice registered by, the higher-ranking secured creditor, a secured creditor can be confident in extending credit on the basis of the value in excess of the maximum amount as the priority of the higher-ranking secured creditor will be limited to the stated maximum amount.

C. Searching the Registry

1. General

139. Part II.B highlights the importance of searching the Registry and what can be done if a search shows that there are competing security rights in the assets described in a notice. Under the Model Law, anyone can search the Registry as long as they use the prescribed search request form and pay the prescribed fees (MRP art. 5(3)).

2. Who should search the Registry, why and when

140. The most usual way of making a security right effective against third parties is to register a notice in the Registry (ML art. 18(1)). This means that a search of the Registry can reveal the potential existence of a security right in an asset. For this reason, any person who might be adversely affected by a security right in an asset should search the Registry to check whether there are any notices that describe that asset. The following sets out who should search the Registry as well as why and when they should do so.

A potential secured creditor

141. A creditor that wants to obtain a security right in an asset should search the Registry at an early stage of its negotiations with the grantor. The search will allow the creditor to determine whether another secured creditor has already registered a notice relating to the asset to be encumbered.

142. The registration of a notice is effective only when the information in the notice is publicly searchable (MRP art. 13). For this reason, a secured creditor should conduct a second search of the Registry immediately after it registers its notice to check that the notice is searchable and that no other notice has been registered since it conducted the first search. If the second search confirms that no notice has been registered since the first search, the secured creditor can disburse funds to the grantor without worrying that another creditor might have obtained a higher-ranking security right by registering ahead of it.

143. However, a secured creditor should be cautious in disbursing funds if the asset was acquired recently by the grantor. This also applies to a secured creditor that has obtained a security right in the grantor's future assets, registered a notice in the Registry and is planning to disburse funds based on a new asset acquired

by the grantor. The reason is that an acquisition secured creditor can obtain priority over a prior-registered secured creditor if the acquisition secured creditor registers its notice before the expiry of a short time period specified by the enacting State (ML art. 38, see section II.G.3). If the secured creditor wants to be sure that there is no higher-ranking acquisition secured creditor in relation to the newly-acquired asset, it needs to conduct a third search after the expiry of that short time period to check whether any notice has been registered in relation to that asset.

144. In enacting States that have chosen option A of article 38 of the Model Law, a secured creditor does not need to conduct this third search if the asset newly acquired by the grantor is inventory or its intellectual property equivalent. This is because an acquisition secured creditor will only have priority over a prior-registered secured creditor in relation to inventory or its intellectual property equivalent, if it had notified the prior-registered secured creditor of its intention to take an acquisition security right in the asset (ML art. 38, option A, para. 2).

A potential buyer or other transferee

145. A person who wants to buy an asset from another person will usually not need to conduct a search of the Registry, particularly if the seller is in the business of selling that type of asset. This is because a person who buys a tangible asset from a seller who sells it in the ordinary course of its business will acquire the asset free of any security right in that asset (ML art. 34(4)). A lessee's right to use a tangible asset is also not affected by any security right in that asset, if the lessee leased the tangible asset from a lessor who leases the asset in the ordinary course of its business (ML art. 34(5)).

146. However, a potential buyer or lessee that intends to purchase or lease a tangible asset from a seller or lessor that does not sell or lease the asset in the ordinary course of its business should search the Registry to check whether the asset may be subject to a security right. This is because the rights of a buyer or lessee are generally subject to a pre-existing security right in the asset that has been made effective against third parties (ML art. 34(1)). If a search of the Registry reveals a notice relating to the asset, the potential buyer or lessee should make further inquiries with the seller or lessor to find out whether it has granted a security right in the asset. If it has, the buyer or lessee could terminate the transaction or ask the seller or lessor to have the security right extinguished before entering into the transaction, similar to measures a potential secured creditor would take when it discovers that there are competing claimants in the asset to be encumbered (see section II.B.4).

Judgment creditors, insolvency representatives and others

147. A creditor that has obtained a judgment or provisional order for payment of what it is owed from a court (a “judgment creditor”) should search the Registry to determine which assets of the judgment debtor may be subject to a security right. While it is possible for a judgment creditor to execute the judgment against the residual value of an encumbered asset, it is generally easier to execute the judgment against an unencumbered asset (on the priority of a judgment creditor, see section II.G.6 and example 26). An insolvency representative should also search the Registry to see whether the debtor’s assets may be subject to a security right. Furthermore, an unsecured creditor should search the Registry as part of its general risk assessment of the debtor. If the debtor is in default, a search of the Registry will assist the unsecured creditor to determine whether there is merit in obtaining a judgment and pursuing execution against the debtor’s asset. Credit rating agencies also often search the Registry as part of their overall assessment of the creditworthiness of a debtor.

3. How to search the Registry

Search criteria

148. A search of the Registry should always be conducted using the name of the grantor. A secured creditor will often also search using the name of the debtor (if the debtor is not the grantor) or any guarantor to assess their creditworthiness as part of an overall assessment of the risks of the transaction. It may also wish to conduct a search using the business or trade name of the grantor as part of the overall assessment.

How to determine the correct name for searching

149. A searcher should use the correct name of the grantor when it searches the Registry. The enacting State will have specified which official document or public record is to be used to determine the correct name of the grantor (MRP art. 9). Depending on the rules specified by the enacting State, this may be a national identity card, birth certificate or driver’s licence for individuals and a public corporate or business register for legal entities. A searcher will therefore need to obtain a copy of the specified official document or search the specified public record before conducting a search in the Registry.

150. Individuals may be hesitant to provide a copy of their official documents to some searchers, for example, to an unsecured creditor seeking to obtain a judgment against a debtor. In that case, the searcher will need to search against all likely names of the individual.

Exact or close match search results

151. In enacting States that opt for an “exact match” system, a search of the Registry will only reveal notices in which the name of the grantor exactly matches the name entered by the searcher (MRP art. 23, option A). In enacting States that opt for a “close match” system, a search will disclose not only exact matches, but also notices in which the name of the grantor closely matches the name entered by the searcher (MRP art. 23, option B). Even in States that provide close match results, a searcher should use the correct name of the grantor when conducting the search to ensure that it obtains a reliable search result.

152. Regardless of the option chosen by the State, a searcher will need to determine whether the notices disclosed in the search result do in fact relate to the relevant person and whether any of the notices includes a description of the asset that the searcher is interested in.

Unauthorized notices

153. The registration of an initial notice might not have been authorized by the grantor. Similarly, the registration of an amendment or cancellation notice might not have been authorized by the secured creditor. A searcher should be aware of the possible consequences of any such unauthorized registration (see, respectively, sections II.E.10 and II.E.11).

4. Situations where a search using a single name may not be sufficient

Where the grantor has changed its name

154. If the grantor has changed its name after a notice has been registered, a search of the Registry using the grantor’s new name will not disclose that notice. For this reason, a searcher should ascertain whether the grantor previously had a different name (section 1(f) and (g) of the Sample Diligence Questionnaire). If the grantor

is a legal entity, a searcher will usually be able to conduct a search of the public records to check if any other name(s) had been used in the past.

155. If the grantor has recently changed its name, a searcher should search using not only the grantor's present name but also its prior name. This is because a secured creditor who registered a notice using the prior name can retain the priority of its security right despite the change of the grantor's name, if it registers an amendment notice that adds the new name before the expiry of the time period specified by the enacting State (MRP art. 25, see section II.E.8 and example 17).

Where an asset was purchased from a person outside its ordinary course of business

Example 15: Company V is in the business of printing newspapers. Bank Y makes a loan to Company V and takes security over Company V's printing press to secure the loan. Bank Y registers a notice in the Registry. The next month, Company V sells the printing press to Company W, which is also in the business of printing newspapers. The sale of the printing press by Company V or a subsequent sale by Company W would be outside the ordinary course of their business.

156. Under the Model Law, a buyer of an encumbered asset will generally acquire the asset subject to the security right if the security right was made effective against third parties before the sale (ML art. 34(1), see section II.G.2). In example 15, Company W acquires the printing press subject to the security right that Company V granted to Bank Y.

157. A prospective buyer should therefore determine not only whether the seller has granted a security right in the asset, but also whether the seller is the original owner of the asset. This is because the seller may have acquired the asset subject to a security right that had been granted by the previous owner. For example, if Company X were to purchase the printing press from Company W, it should search the Registry using not only the name of Company W (the seller) but also the name of Company V (the previous owner). This search will disclose the notice registered by Bank Y, and alert Company X to the fact that the printing press is subject to a security right in favour of Bank Y.

158. The same applies to a prospective secured creditor. If Bank Z were to make a loan to Company W taking security over the printing press, it should search the Registry using not only the name of Company W (the grantor) but also the name of Company V (the previous owner).

159. Where the encumbered asset is transferred, an enacting State may require that the secured creditor register an amendment notice adding the buyer as a new grantor in order to preserve the priority of its security right and its effectiveness against subsequent buyers and secured creditors (MRP art. 26, options A and B, see section II.E.8 and example 19). If the enacting State has chosen these options, Company X and Bank Z would not need to conduct a search of the Registry using the name of Company V if the time period specified by the enacting State to register the amendment notice has expired.

5. Searches in other registries

160. Under the Model Law, the Registry is the place to register notices relating to security rights in most types of movable assets (ML arts. 1(1) and 28). However, some enacting States may require security rights in certain types of assets to be registered in a separate asset-specific registry (ML art. 1(3)(e), see section II.E.12). If the asset to be encumbered or purchased is subject to an asset-based registration regime, a searcher will need to search both the Registry and the other relevant registry.

D. Preparing the security agreement

1. General

161. Once the terms of the secured transaction have been agreed upon and the secured creditor has conducted its due diligence, the parties will need to prepare an agreement that creates a security right in the relevant assets of the grantor in favour of the secured creditor. Such an agreement is referred to as a “security agreement” in the Model Law regardless of how the parties have denominated it (for the definition, see ML art. 2(jj)).

162. A contract under which goods are sold on retention-of-title terms and a financial lease agreement are just two examples of a security agreement (see section II.A.6 and examples 6A and 6D). An agreement for the transfer of a receivable is also regarded as a security agreement under the Model Law, as it applies to outright transfers of receivables (see section II.A.6 and example 10).

163. Two samples of a security agreement, which cover assets owned by the grantor, are available in annex IV (Sample Security Agreements A and B). A sample retention-of-title clause is available in annex V.

2. Requirements for a security agreement

Form requirements – In writing and signed by the grantor

164. As illustrated throughout part A of this chapter, a security agreement needs to be in writing and signed by the grantor. “Writing” includes electronic communications (for the definition, see ML art. 2(*nm*)). Therefore, an agreement entered into via e-mail using electronic signatures will satisfy the requirements.

165. As an exception to the “writing” requirement, a security agreement may be oral if the secured creditor is in possession of the encumbered asset (ML art. 6(4), see section II.A.2). However, parties should still document their agreement in writing to avoid later disputes over its exact terms and for evidentiary purposes.

Minimum content of the security agreement

166. The Model Law prescribes very few requirements for the content of a security agreement. The security agreement must identify the parties (the secured creditor and the grantor), describe the secured obligation, and describe the assets to be encumbered (ML art. 6(3)).

How to describe the secured obligation

167. The security agreement must describe the secured obligation in a manner that reasonably allows it to be identified (ML art. 9(1)). A security right can secure specific existing or future obligations (or both), or all obligations owed to the secured creditor at any time. If the security agreement secures all obligations owed to the secured creditor at any time, a description using those terms is sufficient (ML art. 9(3), see section 2.2 of Sample Security Agreement B).

How to describe the encumbered asset

168. The security agreement must describe the encumbered asset in a manner that reasonably allows it to be identified (ML art. 9(1)). The same applies when registering a notice (MRP art. 11, see section II.E.5). If the encumbered asset is a specific item, a detailed description can be provided (for example, “printing press manufactured by Company A with serial number 1234XYZ”). However, a less detailed description is sufficient if it still enables the encumbered asset to be reasonably identified. For example, a description such as “printing press” is sufficient

if the grantor owns only one printing press. However, if the grantor owns more than one printing press, and the security agreement is intended to cover only one or some of them, a more detailed description will be necessary to identify which printing presses are encumbered.

169. If the encumbered assets are of a generic category, the description in the security agreement only needs to refer to that generic category, for example, “all present and after-acquired inventory”. Similarly, if the security right is intended to cover all the grantor’s present and future movable assets, the assets can be described using those words (ML art. 9(3), see section II.A.5 and example 5).

170. Generic descriptions can be combined with more detailed descriptions if the parties want to exclude some assets from a generic category of encumbered assets (for example, “all present and future receivables owing to the grantor, except receivables owed by X” or “all present and future assets, except inventory manufactured by X”).

Maximum amount for which the security right can be enforced

171. An enacting State may require a security agreement to state the maximum amount for which the security right can be enforced (ML art. 6(3)(d)) and that the same information be included in the notice (MRP art. 8(e), see section II.E.5). This requirement is useful in situations where the value of the encumbered asset significantly exceeds the amount of the obligation secured by that asset. The objective is to make it easier for a grantor to use the residual value of the encumbered asset to obtain financing from other creditors. A secured creditor should set the maximum amount at a level that takes into account the amount it is owed, any potential unpaid interest and any potential enforcement costs.

Example 16: Company X runs five pizza restaurants. Bank Y makes a loan of \$10,000 to Company X. Company X gives Bank Y a security right in its five pizza ovens to secure the loan. In total, the ovens are valued at \$30,000. State A requires the maximum amount for which Bank Y can enforce its security right to be stated in the security agreement and in the notice. Both the security agreement and the notice registered by Bank Y state that the maximum amount is \$12,000.

172. In example 16, Bank Y is secured by its security right in the pizza ovens only up to \$12,000 as stated in the security agreement and the notice. It is unsecured for any loan it makes above that amount. Bank Y will therefore want to be confident that \$12,000 is enough to cover all credit that it intends to extend to Company X

(including the loan of \$10,000) as well as any potential unpaid interest and enforcement costs.

173. Because Bank Y's security right can be enforced up to a maximum of only \$12,000, a subsequent creditor may be willing to extend credit to Company X, secured by the ovens, for the amount by which their estimated market value is greater than the maximum amount stated in the security agreement and the notice (\$18,000). The subsequent secured creditor will also need to take into account possible unpaid interest and enforcement costs, meaning that the amount that it is prepared to lend to Company X will likely be less than \$18,000.

3. Other provisions that can be included in a security agreement

Variations in the structure and content of a security agreement – Party autonomy

174. The structure of a security agreement will vary greatly, depending on the nature of the transaction and the parties' commercial needs. A security agreement will be very short if it includes only the minimum content required by the Model Law (Sample Security Agreement A). However, the parties will usually include other provisions that set out more detailed terms of their agreement. For example, Sample Security Agreement B involves a more complicated transaction where a secured creditor is providing a line of credit and takes security over all of the grantor's present and future assets.

175. The secured creditor and the grantor are generally free to agree on the content of their security agreement (ML art. 3(1), this freedom is referred to as "party autonomy"). For example, the security agreement may include terms on the monitoring of the encumbered assets, on the resolution of disputes arising out of the transaction, on events of default and on measures that a secured creditor can take to enforce its security right (sections 1 and 3 to 6 of Sample Security Agreement B).

Limitations on party autonomy

176. While the parties are given substantial freedom to structure their agreement as they see fit, there are certain limitations (ML art. 3(1)). For example, the parties are obliged to act in good faith and in a commercially reasonable manner (ML art. 4) and they cannot agree to exclude this obligation. Nor can they agree that the secured creditor can retain possession of the encumbered assets after the security

right is extinguished (ML art. 54). A grantor cannot waive unilaterally or vary by agreement any of its rights under the enforcement provisions of the Model Law before default (ML art. 72(3)). Parties should also bear in mind that there may be other laws of the enacting State that limit the scope of their autonomy (for example, laws that limit a secured creditor's ability to accelerate repayment of a loan on default).

Events of default

177. Default occurs when the grantor fails to pay or otherwise perform the secured obligation. A secured creditor and a grantor can also agree on other events that would constitute default (for the definition, see ML art. 2(j)). The following are some events that are typically listed in a security agreement as constituting default.

- The failure by the grantor to pay when due any amount owing
- The insolvency of the grantor
- A third party taking steps to seize or enforce against any of the encumbered assets
- The entry of a judgment against the grantor above a specified amount
- A representation made by the grantor in the security agreement (or in any document delivered to the secured creditor pursuant to the agreement) being false or misleading in a material respect, and
- Any material non-performance by the grantor of any of its other obligations under the agreement

178. Where the grantor is not the debtor of the secured obligation, the events of default should also refer to the debtor to the extent applicable. The security agreement may provide that some of these events will only become an event of default if the circumstances are not remedied within a time period agreed by the parties.

179. Where a security agreement is entered into to secure an obligation that arises under a separate agreement (for example, a loan agreement), the events of default will likely be set out in that separate agreement. In that case, the security agreement should include a cross-reference to the relevant provisions in that other agreement.

Retention-of-title clauses

180. A creditor may wish to take security over an asset by means of a retention-of-title clause. However, retention of title will not give the creditor any greater protection under the Model Law than when it obtains any other type of security right in the asset. Therefore, the decision to use a retention-of-title clause will be driven by business considerations and the type of financing which the creditor provides rather than based on legal considerations (see section II.A.6 and example 6A).

181. Annex V sets out a sample retention-of-title clause, which is quite different in structure from the Sample Security Agreements in annex IV. The sample retention-of-title clause is suitable for use in a sales contract where the seller wants to retain title to the assets until the buyer makes full payment of the purchase price. While the parties can enter into a stand-alone retention-of-title agreement, it is more likely that they will include the clause in the sales contract. The precise terms will need to be adjusted depending on the circumstances, for example, whether the assets are to be used by the grantor as equipment in the operation of its business, or as inventory for resale or in a manufacturing process. The sample retention-of-title clause in annex V deals with the situation where the assets are used as equipment.

E. Registering a notice in the Registry

182. As highlighted throughout this Guide, the most usual way to make a security right effective against third parties is to register a notice in the Registry (ML art. 18). This part provides guidance on who should register a notice, and when and how to register.

183. There are three types of notices under the Model Law: an initial notice, an amendment notice, and a cancellation notice. This part focuses mostly on registering an initial notice. It also discusses the circumstances where the secured creditor should or must register an amendment or cancellation notice as well as the obligations of the secured creditor during the registration process. Lastly, this part explains the consequences when an amendment or cancellation notice is registered without the authorization of the secured creditor.

1. Who should register

184. Registration of a notice is relevant to all types of secured creditors. This includes not only a secured creditor that is a lender but also:

- A seller of goods on retention-of-title terms (see example 6A)
- A lessor under a financial lease (see example 6D), and
- An outright transferee of a receivable (see example 10).

185. In practice, it is the secured creditor that submits a notice in the Registry, even though anyone can submit a notice under the Model Law (MRP art. 5(1)). A secured creditor can delegate the task of registration to another person, such as its lawyer or a registration service provider. Whether the secured creditor registers the notice itself or uses the services of another person, the secured creditor will suffer the consequences if an error or omission makes the registration ineffective. For this reason, a secured creditor should always check to ensure that the registration was done correctly by conducting a follow-up search of the Registry (see section II.C.2). If a secured creditor decides to delegate the task of registration, it should make sure that it has a remedy if the registration is not made correctly (for example, by including an indemnity clause in the service agreement and ensuring that the service provider is insured against liability for its errors).

2. *When to register an initial notice*

186. An initial notice can be registered at any time. It can be done even before the security agreement is entered into, which is often referred to as “advance registration” (MRP art. 4). A secured creditor should consider registering at an early stage of the negotiations with the grantor (for example, as soon as the basic terms of the financing arrangement are agreed upon), because priority between competing security rights in the same asset is generally determined by the order in which the initial notices are registered (see section II.G.1).

187. A secured creditor should, however, be aware that advance registration may not be sufficient to protect its security right as against certain types of competing claimants who acquire rights in the asset before the security agreement is entered into. For example, if the person identified as the grantor in an advance registration sells the asset described in the notice before the security agreement is entered into, the buyer will acquire the asset free of the security right. Similarly, if insolvency proceedings are commenced in respect of the person identified as the grantor before the security agreement is entered into, the security right once created will be ineffective against the insolvency representative.

3. *How to register an initial notice*

188. The registration process is straightforward. To register an initial notice, the secured creditor only needs to do the following (MRP art. 5(1)).

- Submit the notice to the Registry in the prescribed form
- Provide evidence of its identity in the prescribed manner, and
- Pay the required fee (if any)

189. The requirements for registering an amendment or cancellation notice are the same, except that the secured creditor also needs to satisfy the secure access requirements set by the Registry (MRP art. 5(2)).

190. A registration is effective as soon as the information contained in the notice is publicly searchable (MRP art. 13(1)). In most enacting States, the Registry will be electronic, meaning that both registrations and searches can be done directly through the Internet or via a direct network system. A secured creditor will usually be able to conduct a search to verify that the information in the notice is publicly searchable almost immediately after it submits the notice.

191. If available, a secured creditor should follow the guidelines provided by the Registry regarding the registration process. These guidelines typically explain the following.

- How to set up and operate user accounts
- Access protocols for registering and searching (including access IDs or other credentials), and
- Secure access requirements for registering amendment and cancellation notices

4. *Obtaining the grantor's authorization*

192. The registration of an initial notice is effective only if the grantor authorized it in writing (MRP art. 2(1)). The grantor does not need to give the authorization before the registration and can give it later instead (MRP art. 2(4)). If a security agreement is entered into between the parties after the registration, that constitutes authorization for any previously registered notices with respect to the assets that are described in the security agreement (MRP art. 2(5)).

193. The registration of an amendment notice that adds a grantor or adds encumbered assets also requires the grantor's written authorization (MRP art. 2(2) and (3)).

194. While the grantor's authorization is required for the registration to be effective, it is not a formal step in the registration process and the Registry cannot require the secured creditor to show that the grantor authorized the proposed registration (MRP art. 2(6)).

195. A template of a grantor's authorization is contained in annex VI.

5. *What information is required in an initial notice*

196. The following information needs to be included in an initial notice (MRP art. 8).

- The name and address of the grantor
- The name and address of the secured creditor, and
- A description of the encumbered assets

197. Depending on the options chosen by the enacting State, an initial notice may also need to indicate:

- The period of effectiveness of the registration (MRP arts. 8(d) and 14, options B and C), and
- The maximum amount for which the security right may be enforced (ML art. 6(3)(d) and MRP art. 8(e)).

Name and address of the grantor

198. When registering a notice, a secured creditor should enter the correct name of the grantor. This is because a registration will be ineffective if a search using the correct name does not retrieve the notice (MRP art. 24(1) and (2)).

199. The enacting State will have specified the official document or public record that is to be used to determine the correct name of the grantor (MRP art. 9). Depending on the rules specified by the enacting State, this may be a national identity card, birth certificate or driver's licence for individuals and a public corporate or business register for legal entities. A secured creditor should therefore obtain a copy of the specified official document or search the relevant public records to verify the correct name before registering the notice.

200. The secured creditor should also enter the accurate address of the grantor. Entering the grantor's accurate address is useful if a search retrieves notices relating to multiple grantors with the same name. The address can help a searcher to determine whether any of the notices relate to the grantor in which it is interested.

Name and address of the secured creditor or its representative

201. The secured creditor also needs to enter its name and address in the initial notice. Alternatively, it can enter the name and address of its representative. This is useful in situations, for example, where the financing is provided by a group or syndicate of lenders. In that case, the initial notice can set out the name and address of the administrative agent or other representative of the syndicate, rather than setting out the names and addresses of all participating lenders.

202. The enacting State will have specified the official documents or public records to be used to determine the correct name of the secured creditor or its representative. Typically, they will be the same as those for determining the correct name of the grantor (MRP art. 10).

203. Unlike the name of the grantor, the name of the secured creditor or its representative is not a search criterion (MRP art. 22, see section II.C.3). This means that an error in the name of the secured creditor or its representative will generally not make a registration ineffective (MRP art. 24(4)). It is still important for the secured creditor to enter its correct name and accurate address, as this information can be used by third parties to send notices and other communications to the secured creditor. These third parties include, for example, a subsequent secured creditor that intends to obtain an acquisition security right (ML art. 38, option A, para. 2) and a competing secured creditor that intends to enforce its security right (ML arts. 78(4) and 80(2)).

Description of the encumbered assets

204. An initial notice must describe the encumbered assets in a way that reasonably enables them to be identified (MRP art. 11(1); on how to describe the assets, see section II.D.2). This requirement is intended to ensure that searchers can determine which assets of the grantor may be subject to a security right.

205. A secured creditor should avoid describing the encumbered assets in a way that might require it to register an amendment notice because of events that could happen after the registration. For example, a notice should avoid describing assets by their location ("all equipment located at 123 Street, ABC City") unless the

secured creditor is confident that the assets will remain at that location for the duration of the financing.

206. A secured creditor and a grantor may intend to enter into more than one security agreement, such as a series of agreements to finance the grantor's acquisition of several delivery vans over time. In that case, the secured creditor can register a single notice to cover the security rights created under all the agreements, including agreements that will be entered into at a later stage (MRP art. 3). The secured creditor does not need to register a separate notice for each security agreement as long as the description of the encumbered assets in the single initial notice is broad enough to cover the assets to be encumbered by all the agreements. For example, if the secured creditor registers an initial notice that describes the encumbered assets as "all present and future delivery vans", it will not need to register a separate initial notice for any of the subsequent security agreements.

Period of effectiveness of the registration

207. A secured creditor may need to indicate in the initial notice how long the registration will be effective. Whether it must do this depends on the option that the enacting State has chosen with regard to the period of effectiveness of a registration (MRP art. 14). Regardless of the option chosen, a registration can be extended more than once (MRP art. 14(3)).

<p>Option A: The enacting State fixes the period of effectiveness, for example, 5 years.</p>	<p>A secured creditor does not need to indicate the period of effectiveness in the initial notice. It is effective for 5 years.</p> <p>The secured creditor can extend the registration for another 5 years by registering an amendment notice.</p> <p>As an amendment notice can only be registered within a time period (specified by the enacting State) before the registration expires, the secured creditor should put in place a system that will remind it to do this within that time period.</p>
<p>Option B: The enacting State allows a secured creditor to determine the period of effectiveness.</p>	<p>A secured creditor needs to indicate the period of effectiveness in the initial notice.</p> <p>The secured creditor can extend the registration at any time before it expires by registering an amendment notice.</p> <p>A secured creditor can reduce the need to register amendment notices to extend the registration by specifying in the initial notice a period that reflects the expected duration of the financing, including time that might be needed for enforcement after default.</p>

Option C: The enacting State allows a secured creditor to determine the period of effectiveness but puts a cap on the maximum period, for example, 5 years.

A secured creditor needs to indicate the period of effectiveness in the initial notice. It is only effective for up to 5 years.

If 5 years is shorter than the expected duration of the financing (including any time that might be needed for enforcement after default), the secured creditor should extend the registration before it expires by registering an amendment notice.

As an amendment notice can be registered only within a time period (specified by the enacting State) before the registration expires, the secured creditor should put in place a system that will remind it to do this within that time period.

Statement of the maximum amount for which the security right may be enforced

208. A secured creditor may need to state in the initial notice the maximum amount for which its security right can be enforced (MRP art. 8(e)). This depends on whether the enacting State requires the maximum amount to be stated in the security agreement (ML art. 6(3)(d), see section II.D.2 and example 16).

Secured obligation need not be described in the notice

209. While the secured obligation needs to be described in the security agreement (see section II.D.2), it does not need to be described in the initial notice. A secured creditor should ensure that the notice does not include any other information that it wants to keep confidential.

6. Obligation to send a copy of a registered notice to the grantor

210. After a secured creditor submits a notice, it will receive a copy of the information in the registered notice from the Registry. This will include the date and time the notice became accessible to searchers and the registration number assigned to it by the Registry (MRP art. 15(1)).

211. When it receives a copy of the information from the Registry, the secured creditor must send the copy to the grantor within the time period specified by the enacting State (MRP art. 15(2)). A failure to comply with this obligation does not

affect the effectiveness of the registration (MRP art. 15(3)), but the secured creditor will be liable to pay the grantor a nominal amount as specified by the enacting State and any actual loss or damage that the grantor suffered as a result of the secured creditor's failure (MRP art. 15(4)).

212. When it receives the copy of the information from the secured creditor, the grantor should determine whether the description of the encumbered assets correctly reflects its agreement with the secured creditor. If it does not, the grantor can ask the secured creditor to register an amendment or cancellation notice to correct this (see section II.E.10).

7. Who can register an amendment notice

213. Information in a registered notice can be modified by submitting an amendment notice. The only person allowed to register an amendment notice is the person identified in the registration as the secured creditor (MRP art. 16(1)). If an amendment notice is registered to change the secured creditor, only the new secured creditor is allowed to register any subsequent amendment notices (MRP art. 16(2)).

214. The consequences of an amendment notice that is registered without the authorization of the secured creditor are discussed in section 11 below.

8. When and how to register an amendment notice

215. This section discusses the most common circumstances in which a secured creditor should register an amendment notice.

The registered notice contains an error or is incomplete

216. After a notice is registered, the secured creditor will receive a copy of the information in the registered notice from the Registry (MRP art. 15(1)). The secured creditor should immediately check whether that information is accurate and complete, and register an amendment notice if there are any errors or omissions.

217. Like an initial notice, an amendment notice is effective only from the time the information in the notice is publicly searchable (MRP art. 13(1)). Therefore, a secured creditor should register its amendment notice promptly.

The grantor changes its name

218. The grantor's name may change after an initial notice is registered. For example, an individual may change its name legally, or a company may merge with another company and its name could change as a result. To preserve its priority against any subsequent competing secured creditors or buyers of the encumbered asset, the secured creditor needs to register an amendment notice that adds the new name of the grantor before the expiry of the time period specified by the enacting State (MRP art. 25). Otherwise, its security right will not have priority over the security right of a subsequent secured creditor that registered a notice using the grantor's new name. Similarly, its security right will not be effective against a buyer that purchased the encumbered asset from the grantor after the grantor changed its name.

Example 17: John Smith grants Bank Y a security right in his tractor. Bank Y registers an initial notice in the Registry on 18 March identifying John Smith as the grantor. Afterwards, John applies to legally change his first name to Robert. The application is approved and takes effect on 18 June. The enacting State has specified a time period of 90 days for a secured creditor to register an amendment notice to reflect a change in the name of the grantor.

Example 17A: On 1 August, Robert obtains a loan from Bank Z and grants Bank Z a security right in the same tractor. Bank Z registers a notice on the same day identifying Robert Smith as the grantor.

Example 17B: On 1 August, Robert sells the tractor to Buyer Z.

219. In example 17A, Bank Y can preserve its priority against Bank Z by registering an amendment notice that identifies Robert Smith as an additional grantor within 90 days of the name change. If Bank Y does the same in example 17B, its security right will be effective against Buyer Z.

220. Bank Y can register an amendment notice after the expiry of the 90-day period. In that case, however, its priority will not be preserved against Bank Z in example 17A. And Buyer Z will acquire the tractor free of the security right in example 17B.

221. The 90-day period in example 17 is intended to provide a secured creditor (Bank Y) with a reasonable period to find out about a change in the name of the grantor and to register an amendment notice within that period. To protect itself against the priority risk posed by a change in the grantor's name, a secured creditor should periodically check whether the grantor intends to change or has changed its name as part of its ongoing monitoring of the grantor (see section II.F.2).

The secured creditor changes its name or address

222. A secured creditor may change its name or address (or both) after it registers an initial notice. Unlike a change in the name of the grantor, these types of changes do not affect the effectiveness of the registration in any way. Nonetheless, a secured creditor should update registrations in which it is identified as the secured creditor to reflect the change(s). This will ensure that the secured creditor continues to receive any notices or other communications that are sent by third parties using its name and address in the registration.

223. A secured creditor can update its name and address by registering separate amendment notices for each registration in which it is identified as the secured creditor. This could be burdensome, however, if there are many such registrations. In that case, the secured creditor can instead arrange for a single “global” amendment to modify its information in all the registrations (MRP art. 18). Depending on the option chosen by the enacting State, the secured creditor can either register the global amendment notice itself (MRP art. 18, option A) or request the Registry to globally amend the information (MRP art. 18, option B).

The secured creditor transfers the security right

224. A secured creditor may decide to transfer its security right to a new secured creditor after it registers an initial notice. In this case, the new secured creditor should ensure that an amendment notice is registered that identifies it as the secured creditor in the registration. To do this, the new secured creditor needs to request the previous secured creditor to register an amendment notice that replaces its name in the registration with the name of the new secured creditor. The registration of an amendment notice reflecting the transfer of a security right is not required to preserve the third-party effectiveness of the security right. However, it is in the interest of the new secured creditor to have this done, as it will ensure that any notices or other communications sent by third parties using the name and address of the secured creditor in the registration will come to it rather than to the previous secured creditor.

225. The new secured creditor should ask the Registry to provide it with new secure access codes or other credentials for the registration, and to cancel the secure access code or other credentials that were provided to the previous secured creditor. This will remove the risk that the previous secured creditor could continue to make amendments to the registration.

The secured creditor wants to add a description of other assets or change the description of the assets

226. A secured creditor may want to add a description of other assets to the registration. For example, the secured creditor might discover that the description in the initial notice was too narrow and did not cover all the assets that were intended to be subject of the security agreement. Another example would be when the grantor later agrees to provide additional assets as security. In these circumstances, the secured creditor should register an amendment notice that describes the additional assets. As an alternative, the secured creditor could register a new initial notice that covers the additional assets.

227. The same applies if the secured creditor wants to change the current description of the assets in the registration. This will be necessary if the secured creditor realizes that the current description does not reasonably identify the assets, or if it has agreed with the grantor to release some of the assets and instead take security over other assets.

228. Any change to the description of the encumbered asset in a registration only becomes effective when the information in the amendment notice is publicly searchable (MRP art. 13(1)). This means that the security right in the assets that are newly described is likely to be subordinate to any competing security right for which a notice was registered before the amendment notice was registered.

The grantor has disposed of the encumbered asset and the secured creditor needs to add a description of the proceeds

Example 18: Company X obtains a loan from Bank Y. It grants Bank Y a security right in its computer equipment to secure the loan. Bank Y registers an initial notice in the Registry describing the computer equipment. Company X later sells the computer equipment and is paid in cash. Company X uses the cash to purchase a copying machine.

Company X then obtains a loan from Bank Z. It grants Bank Z a security right in the copying machine to secure the loan. Bank Z promptly registers an initial notice of its security right in the Registry describing the copying machine.

229. In example 18, Bank Y's security right in the computer equipment automatically extends to the cash received by Company X and to the copying machine purchased with that money, as proceeds of the computer equipment (see section II.A.7 and example 13).

230. However, Bank Y may need to register an amendment notice that describes the proceeds to preserve the third-party effectiveness and priority of its security right in the proceeds. This depends on what type of asset the proceeds are.

231. If the proceeds are money, receivables, negotiable instruments or funds in a bank account, the security right in the proceeds is effective against third parties without the need to take any additional steps (ML art.19(1)). In example 18, Bank Y's security right in the cash received by Company X is automatically effective against third parties and Bank Y does not need to register an amendment notice.

232. In example 18, Company X then uses the cash to purchase the copying machine. Bank Y's security right in the copying machine is also automatically effective against third parties, but unlike money, receivables, negotiable instruments or funds in a bank account, only for the time period specified by the enacting State (for example, 30 days). It continues to be effective against third parties after 30 days only if Bank Y registers an amendment notice to add the copying machine as an encumbered asset before the 30-day period expires (ML art. 19(2)). If Bank Y does this, its security right in the copying machine has the same priority over a competing security right as its security right in the computer equipment has (ML art. 32). In other words, Bank Y's priority over Bank Z will be preserved. If Bank Y registers an amendment notice after the 30-day period expires, its security right in the copying machine will only be effective against third parties from the time the amendment notice is registered. This means that it would be subordinate to the security right of Bank Z under the first-to-register rule (see section II.G.1).

233. A secured creditor should not rely passively on the automatic extension of its security right to any proceeds of the encumbered asset. It should continuously monitor the encumbered assets to ensure that it finds out about the existence of any proceeds as soon as possible after they arise. The secured creditor will then be able to promptly take the necessary steps to preserve the third-party effectiveness and priority of its security right in the proceeds.

234. Continuous monitoring is important even if the proceeds are money, receivables, negotiable instruments or funds in a bank account. Although a secured creditor does not need to take any action to preserve the third-party effectiveness and priority of its security right in these types of proceeds, the security right continues only as long as the proceeds remain identifiable as being derived from the encumbered asset.

The grantor has disposed of the encumbered asset without authorization, and the secured creditor wants to add the buyer as a new grantor

Example 19: Company V grants Bank Y a security right in its computer equipment. Bank Y registers an initial notice identifying Company V as the grantor and describing the computer equipment. Company V later sells the computer equipment to Company W. The sale is not in the ordinary course of Company V's business.

Example 19A: Company W then grants Bank Z a security right in the computer equipment.

Example 19B: Company W then sells the computer equipment to Company X.

235. Registration of a notice generally protects a secured creditor from an unauthorized sale of the encumbered asset by the grantor. Unless the asset is sold in the ordinary course of the grantor's business, the security right will continue in the asset in the hands of the buyer, who becomes a grantor of the security right under the Model Law (ML arts. 2(o)(ii) and 34, see section II.G.2 and example 22).

236. A secured creditor that has registered an initial notice is generally not required to update the registration to reflect an unauthorized sale of the encumbered asset by the grantor. However, once the asset has been sold and is in the hands of the buyer, a searcher is likely to search the Registry using the name of the buyer. That search will not reveal the initial notice, since it was registered using the name of the original grantor (the seller). For this reason, the secured creditor may need to register an amendment notice adding the buyer as a grantor in order to preserve the third-party effectiveness and priority of its security right against any subsequent secured creditors or buyers. Whether and when this is necessary depends on which option in article 26 of the Model Registry Provisions is chosen by the enacting State.

Option A	<p>Bank Y needs to register an amendment notice that adds the buyer (Company W) as a new grantor after the sale and before the expiry of the time period specified by the enacting State.</p> <p>This is necessary to preserve the third-party effectiveness and priority of Bank Y's security right as against a subsequent secured creditor who is granted a security right by Company W (Bank Z in example 19A) and as against a subsequent buyer who purchases the asset from Company W (Company X in example 19B).</p>
Option B	<p>Bank Y needs to do the same as for option A, but the time period for Bank Y to register an amendment notice does not begin until Bank Y finds out that Company V sold the computer equipment to Company W.</p>
Option C	<p>Bank Y does not need to register an amendment notice or take any other step to preserve the third-party effectiveness and priority of its security right against a subsequent secured creditor (Bank Z in example 19A) or a subsequent buyer (Company X in example 19B).</p> <p>Despite this, Bank Y may still want to register an amendment notice that adds Company W as a new grantor. This will ensure that searchers of the Registry are made aware of Bank Y's security right in the computer equipment in the hands of Company W.</p> <p>In enacting States that have chosen this option, the burden is on Bank Z in example 19A and Company X in example 19B to investigate whether Company W acquired the computer equipment subject to a security right granted by a previous owner (Company V) (see section II.C.4 and example 15).</p>

237. In enacting States that have chosen either option A or B, Bank Y can register an amendment notice even after the time period specified by the enacting State expires. However, Bank Y will not have priority over a subsequent secured creditor that registered its initial notice, or a subsequent buyer that purchased the computer equipment, before Bank Y registered the amendment notice.

The secured creditor wants to extend the period of effectiveness of the registration

238. If a secured creditor expects that the period of effectiveness of its registration will need to be extended so that its security right continues to be effective against third parties, it should register an amendment notice extending the period (MRP art. 14(2), see section II.E.5).

239. If an amendment notice extending the period of effectiveness is not registered and the registration expires, the security right will no longer be effective against third parties. While third-party effectiveness can be re-established by

registering a new initial notice, the security right will be effective against third parties only as of the time the new notice is publicly searchable (ML art. 22).

9. *Who can register a cancellation notice, when and how?*

240. A security right is extinguished when all secured obligations have been discharged and there are no outstanding commitments to extend credit (ML art. 12, see part II.H). As the only person allowed to register a cancellation notice is the person identified as the secured creditor in the registration, the secured creditor should register a cancellation notice when the security right is extinguished (MRP art. 16). The only information required in the cancellation notice is the registration number of the initial notice (MRP art. 19).

241. A secured creditor should be particularly careful when submitting a cancellation notice, because its registration will cease to be effective once the cancellation notice is registered. If the registration relates to security rights created under several security agreements, for example, the secured creditor should not register a cancellation notice simply because an obligation secured under one of the security agreements has been satisfied. Instead, it should register an amendment notice which removes the relevant obligation. Similarly, if a registration relates to more than one grantor, the secured creditor should not register a cancellation notice simply because one of the grantors is being released. Instead, it should register an amendment notice to remove that grantor from the registration.

10. *Obligation to register an amendment or cancellation notice*

242. It will be difficult for the person identified as the grantor in a registration to sell or grant a security right in assets described therein even if those assets are in fact not encumbered.

243. This situation could arise, for example:

- If a secured creditor registered a notice in anticipation of entering into a security agreement, but the transaction eventually did not take place
- If the obligations secured by a security right to which the registration relates have been satisfied and the parties do not intend to enter into any future security agreement, and
- If the description of the encumbered assets in the registration is overly broad and includes assets which were not intended to be encumbered.

244. The following table sets out the circumstances where the secured creditor is required to register an amendment or cancellation notice.

Circumstances	What the secured creditor must do
<p>The grantor has not authorized a registration in relation to some of the assets described in the registration and has told the secured creditor that it will not do so (MRP art. 20(1)(a)).</p> <p>The grantor authorized the registration in relation to all the assets described therein, but a security agreement has not been entered into for some of the assets and the grantor has withdrawn its authorization with respect to those assets (MRP art. 20(1)(c)).</p>	<p>Register an amendment notice that deletes the assets from the description in the registered notice.</p>
<p>The grantor has not authorized the registration at all and has told the secured creditor that it will not do so (MRP art. 20(3)(a)).</p> <p>The grantor authorized the registration, but no security agreement has been entered into and the grantor has withdrawn its authorization (MRP art. 20(3)(b)).</p>	<p>Register a cancellation notice.</p>
<p>The security agreement has been amended to release some assets, and the grantor has not otherwise authorized a registration covering those assets (MRP art. 20(1)(b)).</p>	<p>Register an amendment notice that deletes the assets from the registered notice.</p>
<p>The security right to which the registration relates has been extinguished (MRP art. 20(3)(c), see part II.H).</p>	<p>Register a cancellation notice.</p>

245. A secured creditor can charge a fee for registering an amendment or cancellation notice only in the last two circumstances mentioned in the table (MRP art. 20(4)).

246. In most cases, a secured creditor will voluntarily comply with its obligation to register an amendment or cancellation notice. If it does not, the grantor can send a written request to the secured creditor asking it to do so. In that case, the secured creditor cannot charge a fee for registering the requested notice even in the last two circumstances mentioned in the table (MRP art. 20(5)). A template for requesting the registration of an amendment or cancellation notice is provided in annex VII.

247. If, after receiving the grantor's request, the secured creditor does not register the requested notice within the time period specified by the enacting State, the grantor can apply to the court or other authority specified by the enacting State to issue an order for the registration of the notice (MRP art. 20(6)). If the order is issued, the Registry must register the notice without delay (MRP art. 20(7)).

11. *Unauthorized registration of an amendment or cancellation notice*

248. Only the person identified in a registration as the secured creditor is allowed to submit an amendment or cancellation notice (see sections II.E.7 and 9). To do so, the secured creditor will need to satisfy the secure access requirements set by the Registry (MRP art. 5(2)). Secured creditors should take care to maintain the confidentiality of the secure access codes or other credentials issued to them in order to guard against the risk of unauthorized registration of an amendment or cancellation notice. However, a secured creditor's precautionary efforts may prove insufficient.

249. The Model Law, therefore, provides enacting States with options for dealing with the situation where an amendment or cancellation notice is registered without the secured creditor's authorization (MRP art. 21). The following table sets out the consequences of the unauthorized registration of an amendment or cancellation notice under the different options.

	The effectiveness of an unauthorized amendment or cancellation notice	The consequence
Option A	<p>The unauthorized amendment notice is effective.</p> <p>The unauthorized cancellation notice is effective.</p>	<p>The registration to which the amendment notice relates is amended in accordance with the amendment notice.</p> <p>The registration to which the cancellation notice relates is no longer effective.</p>

Option B	<p>The unauthorized amendment or cancellation notice is effective.</p> <p>There is an exception with respect to a competing claimant whose rights arose before the unauthorized registration and over which the secured creditor had priority before the unauthorized registration.</p>	<p>The result is the same as under option A, except that the priority of the security right is preserved as against the competing claimant referred to in the left column.</p>
Option C	<p>The unauthorized amendment notice is ineffective.</p> <p>The unauthorized cancellation notice is ineffective.</p>	<p>The registration to which the amendment notice relates is not affected by the amendment notice.</p> <p>The registration to which the cancellation notice relates is not affected by the cancellation notice.</p>
Option D	<p>The unauthorized amendment or cancellation notice is ineffective.</p> <p>There is an exception with respect to a competing claimant who searched the Registry after the unauthorized registration and did not know that the registration was unauthorized when it acquired its right.</p>	<p>The result is the same as under option C, except with respect to a competing claimant referred to in the left column. The registration to which an unauthorized amendment relates is amended in accordance with the amendment notice and the registration to which an unauthorized cancellation relates is no longer effective.</p>

250. In enacting States that have chosen option A or B, the secured creditor should register an amendment notice correcting the amended information as soon as it becomes aware that an amendment notice has been registered without its authorization. For example, if the unauthorized amendment notice deleted some assets from the description of encumbered assets in the registration, the secured creditor should register an amendment notice to add those assets back into the registration. The secured creditor should, however, bear in mind that the registration of the new amendment notice makes its security right in those assets effective against third parties only from the time it is registered (in enacting States that have chosen option B, however, the secured creditor will continue to have priority over the competing claimants described in the table above).

251. Similarly, in enacting States that have chosen option A or B, the secured creditor should register a new initial notice as soon as it becomes aware that a

cancellation notice has been registered without its authorization. However, the registration of the new initial notice only makes the security right effective against third parties from the time it is registered (in enacting States that have chosen option B, however, the secured creditor will continue to have priority over the competing claimants described in the table above).

252. In enacting States that have chosen option C, the secured creditor does not need to register a new initial notice or an amendment notice because the registration is not affected by the unauthorized amendment or cancellation notice. The same applies in enacting States that have chosen option D except as against the competing claimants described in the table above. To protect itself against these competing claimants, the secured creditor should register a new initial notice, although this will provide protection only if the new initial notice is registered before the competing claimant acquires its rights.

253. More generally and regardless of the option chosen by the enacting State, a secured creditor should consider whether it can take action against the third party that registered an amendment or cancellation notice without its authorization, for example to recover damages for any loss.

254. In enacting States that have chosen option A or B, the registration of a cancellation notice results in all related notices being removed from the public records of the Registry, so that a search will no longer disclose the security right to which the cancellation notice relates (MRP art. 30, option A). This does not affect the information needs of searchers because the cancellation notice is effective even if its registration was not authorized. This is the case even under option B because the exception only relates to competing claimants whose rights in the asset arose before the unauthorized registration.

255. In enacting States that have chosen option C or D, the registration of a cancellation notice does not result in the related notices being removed from the public records of the Registry (MRP art. 30, option B, para. 2). A search using the name of the grantor will continue to disclose the cancellation notice and all related notices.

256. The same applies under all options when an amendment notice is registered. The information in the registration that was modified will continue to appear in the search result. However, in enacting States that have chosen option C or D, an unauthorized cancellation or amendment notice would generally not be effective. This means that searchers in those States who are interested in the assets described in a registered cancellation or amendment notice will need to contact the secured creditor or conduct other inquiries to verify whether it authorized the registration.

12. *Registration in other registries*

257. Under the Model Law, the Registry is the place to register notices relating to security rights in most types of movable assets (ML arts. 1(1) and 28). However, some enacting States may require rights in certain types of assets to be registered in a separate asset-specific registry (ML art. 1(3)(e)). There may also be international registries established by international conventions that apply in the enacting State. The following are some examples of assets that may be subject to a specialized registration regime.

- Trademarks, patents and copyrights
- Motor vehicles
- Aircraft frames, aircraft engines and helicopters
- Ships, and
- Assets associated with immovable property (for example, timber, growing crops, attachments to immovables, rents or other revenue streams derived from immovable property)

F. **The need for continued monitoring**

1. *General*

258. Due diligence is not merely something to be conducted at the outset of a secured transaction (see part II.B). A secured creditor should continue to monitor the grantor and the encumbered asset throughout the entire duration of the transaction. This will increase the likelihood that the secured creditor will ultimately recover all that it is owed, either directly from the grantor or by enforcing its security right in the encumbered asset.

259. This part discusses basic tools that a secured creditor can use to monitor a secured transaction. Some of these tools relate to the monitoring of the grantor, while others relate to the monitoring of the encumbered asset. These tools will usually be agreed in the security agreement.

260. Monitoring tools for secured lending are typically used in addition to, and not in substitution of, monitoring tools for unsecured lending. This means that a secured creditor should also monitor the debtor (particularly, if different to the grantor) throughout the duration of the loan (for example, by requiring the debtor to agree to provide periodic financial statements and to comply with various

financial and other covenants). This part, however, focuses on monitoring as it relates to a secured transaction.

261. The appropriate tools to use for monitoring will depend on a number of factors, including who the grantor is, the type of secured transaction, and the type of encumbered asset. The extent to which monitoring is necessary will also have an impact on the cost of financing. A secured creditor can use third parties for monitoring as with conducting due diligence.

262. Monitoring should not unduly interfere with the grantor's ability to conduct its business. In setting out the secured creditor's monitoring rights, a security agreement will often contain provisions specifying the number and frequency of appraisals and inspections that the secured creditor can conduct and when they can be done (for example, after giving the grantor reasonable notice, and only during the grantor's normal business hours, see section 4.2 of Sample Security Agreement B).

263. If the grantor is in default, however, the secured creditor should be able to undertake inspections with less deference to their effect on the operation of the grantor's business. For example, a security agreement may state that the secured creditor can conduct an unlimited number of inspections if the grantor is in default.

2. *Continued monitoring of the grantor*

264. A secured creditor should conduct periodic monitoring of the grantor to detect changes that may require additional action to protect its security right. In particular, a secured creditor will want to monitor any changes in the grantor's name and address as well as any mergers or other changes affecting the grantor's legal status, because the secured creditor may need to register an amendment notice (see section II.E.8 and example 17).

265. A secured creditor should also monitor whether any claims have been made against the grantor by third parties, particularly claims that may have priority over its security right (see sections II.G.5 and 6 as well as examples 25 and 26). A secured creditor should ask the grantor or search the relevant registries to determine whether any such claims exist and deal with them accordingly (for example, by requiring that the claims be paid or be subordinated to the secured creditor's security right). A security agreement typically gives the secured creditor the right to withhold further credit until this is done. A secured creditor should also monitor the commencement of any insolvency proceedings with respect to the grantor so that it can respond appropriately.

3. Continued monitoring of the encumbered asset

266. A secured creditor should regularly monitor the encumbered asset. This is important for all types of secured transactions. For example, when a secured creditor takes security over an item of equipment, it should check whether the equipment remains in the agreed location and is being properly maintained. It should also check that the grantor is in possession of the equipment and has not disposed of it. If the grantor has disposed of the equipment, the secured creditor may need to register an amendment notice to protect its security right (see section II.E.8 and examples 18 and 19). The same applies to other types of encumbered assets.

Example 20: Company X sells kitchen appliances to restaurant owners. Many of its sales are on credit and the restaurant owners are given 60 days to pay for the appliances. Bank Y provides Company X with a line of credit, under which Company X can draw down a loan when it needs money to buy inventory or pay other expenses before it is paid by the restaurant owners. Company X gives Bank Y a security right in all its existing and future inventory and receivables to secure the line of credit.

267. Monitoring of the encumbered asset is particularly important in the case of a revolving loan secured by inventory and receivables, where the amount of credit that the lender is prepared to make available depends on the value of the inventory and receivables. In example 20, borrowings and repayments will be frequent, and the amount of the loan will constantly fluctuate. The pool of encumbered inventory and receivables will also fluctuate as inventory is acquired and converted into receivables, the receivables are collected, and new inventory is acquired. The overall amount of the loan that Bank Y is willing to provide to Company X will depend largely on Bank Y's valuation of the encumbered inventory and receivables from time to time. This means that Bank Y needs to monitor the pool of inventory and receivables on an ongoing basis.

268. A secured creditor should therefore ensure that the security agreement provides that it can undertake appropriate monitoring and lists the ways in which this can be done. For example, the security agreement may require the grantor to advise the secured creditor of any significant change in the pool of inventory and receivables including the change in location of the inventory. The security agreement may also require the grantor to provide the secured creditor with updated information about the inventory and receivables on a regular basis (for example, every week or every month or whenever a loan is drawn down). The secured creditor can use this information to ensure that the outstanding principal amount of the loan never exceeds an appropriate

proportion of the value of the underlying pool of inventory and receivables. This amount is often referred to as the “borrowing base”. Annex VIII provides a sample template of a borrowing base certificate.

269. In example 20, the agreement between Company X and Bank Y will usually state that if the outstanding loan amount exceeds the borrowing base, Company X is required to repay the excess amount. Company X’s failure to make this repayment will likely be an event of default (see section II.D.3) and will entitle Bank Y to enforce its security right. In this way, Bank Y can ensure that Company X’s obligations under the agreement are adequately secured by the encumbered assets at all times.

270. Bank Y should not rely simply on a borrowing base certificate. Rather, Bank Y should consider including provisions in the security agreement that allow it to take other steps on a regular basis to verify the value of the encumbered assets. In the case of the inventory, Bank Y can, for example, arrange for a periodic appraisal or inspection. In the case of the receivables, Bank Y can periodically verify the existence and face amount of the receivables by contacting the debtors of the receivables.

271. Bank Y may also want to include the right to conduct on-site inspections in the security agreement, during which its representative will visit Company X’s premises, review its books and records, and inspect the inventory that is on hand. One benefit of an inspection is that it may uncover inadvertent or intentional actions by Company X that could have an adverse impact on Bank Y’s security right. For example, Company X might have relocated the inventory from a warehouse whose operator had entered into an access agreement with Bank Y to another warehouse whose operator had not entered into a similar agreement with Bank Y. The change in location may be revealed by an on-site inspection, and Bank Y can then address the issue by obtaining an access agreement from the new warehouse operator.

G. Determining the priority of a security right

272. A secured creditor may find that its security right in an encumbered asset is in competition with the rights of one or more competing claimants in the same asset. Such rights may have been in existence before the secured creditor entered into the secured transaction (see section II.B.3) or may have arisen afterwards. Also, the priority of a security right may change over the life of the transaction. Ultimately, its rank will be determined at the time the security right is enforced against the encumbered asset.

273. This part explains how the priority rules of the Model Law resolve a competition between a security right in an encumbered asset and the right of a competing claimant in the same asset. While this part is written mainly from the perspective of a secured creditor, it will also help competing claimants to understand their rights under the Model Law.

1. *Competing secured creditors and the first-to-register rule*

Example 21: Company X has a printing business and obtains a loan of €10,000 from Bank Y. Bank Y obtains a security right in Company X's printing press to secure the loan and registers a notice in the Registry. Afterwards, Company X obtains a loan of €8,000 from Bank Z. Bank Z also takes a security right in the printing press and registers a notice in the Registry.

274. In example 21, Company X has granted two security rights in the printing press. This creates a priority competition between two secured creditors, Bank Y and Bank Z. The general rule is that priority between competing security rights is determined by the order in which notices relating to the security rights are registered in the Registry (ML art. 29(a)). Because Bank Y registered its notice first in example 21, Bank Y has priority over Bank Z.

275. Bank Z could have made its security right effective against third parties by taking possession of the printing press (ML art. 18(2), see section II.A.3). However, Bank Z would only have priority over Bank Y, if it had taken and retained possession of the printing press before Bank Y registered its notice (ML art. 29(b)).

276. The priority of a security right is not affected by the fact that the secured creditor knew or may have known of the existence of a competing security right when it obtained its own security right (ML art. 45). For example, even if Company X had entered into a security agreement with Bank Z before Bank Y, and Bank Y had known about it, Bank Y would have priority over Bank Z as it registered first.

2. *Buyers, lessees and licensees of an encumbered asset*

Example 22: Cafe X has a coffee machine and obtains a loan from Bank Y. Bank Y takes security over the coffee machine to secure the loan and registers a notice in the Registry. Afterwards, Cafe X sells the coffee machine to Company Z for cash.

The general rule

277. The general rule of the Model Law is that a security right in an asset that has been made effective against third parties is not affected by a sale, lease or licence of the asset (ML art. 34(1)). This means that a buyer, lessee or licensee of an encumbered asset acquires its rights in the asset subject to the security right. In example 22, Company Z, therefore, acquires the coffee machine subject to Bank Y's security right. It would have been prudent for Company Z to search the Registry before buying the coffee machine to see whether it may be subject to a security right (see section II.C.2). However, there are a few exceptions to this general rule.

Exception 1 – Sale, lease or licence of an encumbered asset with the secured creditor's agreement

278. The first exception is where the secured creditor agrees that the encumbered asset can be sold free of the security right (ML art. 34(2)). If Bank Y had agreed that Cafe X could sell the coffee machine free of Bank Y's security right, Company Z would have acquired the coffee machine free of Bank Y's security right. The result is the same if Bank Y had instead agreed that Cafe X could lease or license the coffee machine unaffected by its security right (ML art. 34(3)). In that case, Company Z's right to use the coffee machine under the lease or licence would not be affected by Bank Y's security right. Bank Y might be willing to agree to the sale, lease or licence of the coffee machine because its security right will extend to the cash received by Cafe X from the sale or the revenue from the lease or licence (see section II.A.7 and examples 13 and 18).

Exception 2 – Sale, lease or licence of an encumbered asset in the ordinary course of business of the grantor

279. Another exception is where the grantor sells a tangible encumbered asset in the ordinary course of its business. In that case, the buyer will usually acquire the asset free of the security right (ML art. 34(4)). For example, if Cafe X were in the business of selling coffee machines, Company Z would have acquired the coffee machine free of Bank Y's security right, regardless of whether Bank Y had agreed to the sale. This exception applies only to buyers, and not to other transferees, for example, a person who obtains the encumbered asset as a gift. A similar exception applies where the tangible encumbered asset is leased in the ordinary course of the grantor's business (ML art. 34(5)). This means the rights of the lessee are not affected by Bank Y's security right. A similar exception also applies to the rights of

a non-exclusive licensee of an intangible encumbered asset, for example, intellectual property (ML arts. 34(6) and 50).

280. There is one qualification to this exception. Company Z would not acquire the coffee machine free of Bank Y's security right if it knew that the sale was in breach of the terms of the security agreement between Cafe X and Bank Y (ML art. 34(4)). In that case, Company Z would acquire the coffee machine subject to Bank Y's security right.

281. Company Z may have known or may have been able to find out that Bank Y had a security right in the coffee machine because Bank Y had registered a notice in the Registry. However, this would not result in Company Z acquiring the coffee machine subject to Bank Y's security right, as mere knowledge of the existence of a security right is irrelevant for priority purposes. Company Z would only lose the benefit of the protection if it knew that the sale was in breach of the security agreement (ML art. 34(4)). And if the sale were in breach of the security agreement, Bank Y would be able to claim damages against Cafe X for that breach.

3. *Super-priority of an acquisition security right*

Example 23: Bank Y makes a loan to Company X, which operates a printing business. Bank Y takes security over all of Company X's equipment and inventory to secure the loan, including equipment and inventory that Company X will buy in the future. Bank Y registers a notice in the Registry. Afterwards, Company X purchases some computers for use at its headquarters and some paper to print brochures for its customers from Vendor Z. Vendor Z's terms of sale state that it retains title to the computers and the paper until Company X has paid the purchase price in full.

282. In example 23, both Bank Y and Vendor Z have a security right in the computers and the paper purchased by Company X. Under the general first-to-register rule, Bank Y would have priority over Vendor Z because its notice covered the computers and the paper (as future equipment and inventory) and was registered first.

283. However, the Model Law has a special priority rule for an acquisition secured creditor such as Vendor Z in example 23, whose financing enables Company X to acquire the encumbered asset (see examples 6A to 6D). By complying with article 38 of the Model Law, Vendor Z will have priority over a competing non-acquisition secured creditor, even if the competing non-acquisition secured

creditor previously registered a notice covering future assets of the kind subject to the acquisition security right.

284. This is different from the approach taken in many traditional legal systems, where Vendor Z, by simply retaining ownership, will have priority over competing claimants regardless of whether Vendor Z had registered its notice. The Model Law achieves similar results through its priority rule and as long as the acquisition secured creditor satisfies the requirements of the Model Law, it will have priority over competing claimants.

285. Vendor Z has an acquisition security right in the computers. Company X bought the computers for the operation of its business, so they are “equipment” under the Model Law (for the definition, see ML art. 2(1)). Vendor Z will have priority over Bank Y if Vendor Z registers a notice in the Registry before the expiry of the time period specified by the enacting State, which starts to run from the date Vendor Z delivers the computers to Company X (ML art. 38, options A and B, para. 1).

286. Vendor Z also has an acquisition security right in the paper. Company X bought the paper to print brochures for its customers, so the paper is “inventory” under the Model Law (for the definition, see ML art. 2(q)). The steps that Vendor Z needs to take to have priority over Bank Y depend on whether the enacting State has chosen option A or B of article 38 of the Model Law.

- If the enacting State has chosen option A, Vendor Z will have priority over Bank Y if it registers a notice in the Registry and notifies Bank Y that it is taking security over the paper, before it delivers the paper to Company X (ML art. 38, option A, paras. 2 and 4).
- If the enacting State has chosen option B, the rule is the same as for an acquisition security right in equipment (ML art. 38, option B, para. 1). This means that as with the computers, Vendor Z will have priority over Bank Y in the paper if it registers a notice in the Registry before the expiry of the time period specified by the enacting State, which starts to run from the date Vendor Z delivers the paper to Company X.

287. Accordingly, Bank Y should be careful if it plans to lend money based on the value of computers and paper acquired by Company X on the assumption that it will have the highest-ranking security right because it had registered its notice first. To be sure that it has priority in the computers and paper acquired by Company X after it registers its notice, Bank Y should search the Registry after the expiry of the specified time period to see whether an acquisition secured creditor has registered a notice covering those assets (see section II.C.2). However, this may not be necessary with regard to the paper if the enacting State has chosen option A, as

Vendor Z will only have priority if it notified Bank Y of its intention to take a security right in the paper before it delivered the paper to Company X.

288. An acquisition security right in consumer goods, however, is subject to different rules (for the definition of “consumer goods”, see ML art. 2(f)). If the acquisition price of the consumer goods is below the threshold amount specified by the enacting State, the acquisition security right is automatically effective against third parties upon its creation, without the secured creditor needing to register a notice or take any other action (ML art. 24). If the acquisition price exceeds the specified threshold amount, the acquisition secured creditor needs to register a notice to make its right effective against third parties. In both cases, the acquisition secured creditor would have priority over a competing non-acquisition secured creditor (ML art. 38, option A, para. 3 and option B, para. 2), without the need to take the steps mentioned above for equipment or inventory. However, the acquisition secured creditor may in any case wish to register a notice in the Registry. This is because a buyer who purchases those goods from the grantor will acquire them free of the acquisition security right and the rights of a lessee who leases those goods from the grantor will not be affected by the acquisition security right, unless a notice is registered before the buyer or the lessee acquires its rights (ML art. 34(9)).

4. *Impact of the grantor’s insolvency*

Example 24: Bank Y makes a loan to Company X and obtains a security right in Company X’s inventory and receivables to secure the loan. Bank Y registers a notice in the Registry. Company X’s business later fails. Company X files for insolvency.

289. If a security right has been made effective against third parties, it will remain effective against third parties even if the grantor becomes insolvent. The commencement of insolvency proceedings by or against the grantor will also not affect the priority of a security right, unless the insolvency law of the enacting State gives priority to other claimants (ML art. 35). For example, the grantor’s insolvency representative may have priority over secured creditors in recovering the costs of the insolvency proceedings.

290. In example 24, Bank Y’s security right will be recognized in the insolvency proceedings and will retain its priority unless the insolvency law of the enacting State provides otherwise. Under the insolvency law of some States, however, it may be possible to bring an action to avoid a transaction,

for example, if Bank Y had made the loan and obtained the security right within a specified period before the commencement of the insolvency proceedings.

5. Preferential claims

Example 25: Bank Y makes a loan to Company X and obtains a security right in Company X's inventory and receivables to secure the loan. Bank Y registers a notice in the Registry. Company X struggles to manage its cash flow and is late in paying its taxes and the wages of its employees.

291. As a matter of policy, an enacting State may give certain claims priority over a security right even if the security right has been made effective against third parties (ML art. 36). Examples of claims that are given priority by some States include claims for unpaid taxes and claims by the grantor's employees for unpaid wages. These claims, which arise by operation of other laws of the enacting State, are referred to in the Model Law as "preferential claims". The Guide to Enactment of the Model Law suggests that preferential claims, if any, should be listed in a clear and specific way when the enacting State adopts the Model Law, and that a cap should be set on the amount of the claim that will be given priority.

292. A secured creditor should check whether and what type of preferential claims are recognized by the enacting State, as they will have an impact on the priority of its security right. For example, if the enacting State in example 25 gives priority to claims for unpaid taxes up to £10,000 and claims for unpaid wages up to three months and up to £10,000 per employee, Bank Y should calculate the potential total amount and deduct it from the amount of credit that it would otherwise be prepared to extend (sections 8 and 9 of the Sample Diligence Questionnaire).

6. Judgment creditors

Example 26: Bank Y makes an unsecured loan to Company X. Company X does not repay the loan when due and Bank Y obtains a judgment ordering payment from the court. The law of the enacting State requires a creditor who has obtained a judgment to register a notice of the judgment in the Registry in order for the creditor to acquire rights in the debtor's movable assets.

Company X borrows money from Bank Z. Bank Z obtains a security right in Company X's printing press to secure the loan. Bank Z registers a notice in the Registry.

293. A creditor that has obtained a judgment or provisional order from a court for payment of what it is owed (a "judgment creditor") may have priority over a secured creditor if it takes the steps to acquire rights in the debtor's assets that is required by the enacting State.

294. If a judgment creditor takes those steps against an encumbered asset before the secured creditor makes its security right effective against third parties, the judgment creditor has priority over the secured creditor (ML art. 37(1)). In example 26, if Bank Y registers a notice of the judgment in the Registry before Bank Z registers its notice, Bank Y will have priority.

295. If a secured creditor made its security right effective against third parties before or at the time the judgment creditor acquired its right, the secured creditor has priority over the judgment creditor. That priority is, however, limited (ML art. 37(2)). In example 26, if Bank Z registers its notice before Bank Y registers a notice of the judgment, Bank Z has priority. But its priority is limited to the amount of credit that it had already provided to Company X and any further amount that it had already committed to extend before Bank Y notified Bank Z that it had registered a notice of the judgment in the Registry. This limitation prevents Bank Z from unduly increasing the amount owed by Company X after it finds out that Bank Y, a judgment creditor, has taken the necessary steps to acquire rights in the encumbered asset.

296. A judgment creditor should conduct a search of the Registry both before and after it obtains a judgment to check whether any notice has been registered in relation to any of the debtor's assets. Whether or not a notice has been registered, the judgment creditor should take the steps required by the enacting State to acquire rights in the debtor's assets and notify any secured creditor that has registered a notice using the name of the debtor that it has taken those steps. The judgment creditor should do this as soon as possible to maximize its recovery prospects.

H. Extinguishment of a security right by satisfaction of the secured obligation

Example 27A: Company X obtains a loan from Bank Y. Bank Y obtains a security right in Company X's printing press to secure the loan. Company X repays the loan in full.

Example 27B: Company X purchases drilling equipment from Vendor Z. The terms of the sale give Company X 30 days to pay for the drilling equipment and state that Vendor Z retains title to the drilling equipment until Company X pays the purchase price in full. Company X pays the full amount after 20 days.

Example 27C: Company X obtains a revolving line of credit from Bank Y, under which Company X can draw down loans from time to time when it needs money to buy inventory or pay other expenses. Bank Y obtains a security right in all of Company X's existing and future inventory and receivables to secure the revolving line of credit.

297. A security right is extinguished when all the secured obligations have been satisfied in full and the secured creditor is not under any commitment to extend further credit that would be secured by the security right (ML art. 12). In example 27A, Bank Y's security right is extinguished as Company X has repaid the loan in full, unless there is an ongoing commitment by Bank Y to extend additional secured credit. In example 27B, Vendor Z's security right is extinguished as Company X has paid the purchase price in full. In contrast, Bank Y's security right in example 27C will not be extinguished even if Company X pays the outstanding balance of the line of credit in full, if Bank Y remains committed to extend further credit.

298. When a security right is extinguished, the secured creditor is required to register a cancellation notice (MRP art. 20(3)(c), see sections II.E.9 and 10). If the secured creditor made its security right effective against third parties by taking possession of the encumbered asset, it must return the asset to the grantor or deliver it to the person designated by the grantor (ML art. 54).

I. How to enforce a security right

1. Default and options for a secured creditor

299. The occurrence of an event of default is a defining moment in a secured transaction. It is when the secured creditor will rely most on the effectiveness of its security right. A common default under a security agreement is the failure of

the debtor to pay the secured obligation, but parties can also agree on other events of default in the security agreement (see section II.D.3), subject to any restrictions in other laws.

300. If there is default, the secured creditor is entitled to enforce its security right as described in this part. However, there are a number of other things that the secured creditor can do. For example, the secured creditor can offer to restructure the repayment schedule, take security over additional assets, or assign its right to payment of the secured obligation along with the security right to a third party. These options may be preferable to enforcing the security right, particularly if the expected proceeds of the enforcement after deducting enforcement costs may be less than what is needed to discharge the secured obligation in full, as the secured creditor may not be able to recover all that it is owed.

301. In most cases, a security right will secure an obligation to pay money. However, it may also secure other types of obligations, for example, an obligation to provide services under a contract (see section II.A.4). In such a case, the secured creditor will not be able to use the enforcement mechanism in the Model Law to make the grantor perform the services. This means that the secured creditor needs to convert the secured obligation into an obligation to pay money (for example, into damages for the breach of the secured obligation), and then use the Model Law's enforcement mechanism to recover that money. The secured creditor can also rely on other laws of the enacting State that provide a mechanism to enforce the performance of the services.

2. *The basics of enforcement under the Model Law*

302. A security right makes it possible for the secured creditor to recover what it is owed from the value of the encumbered asset. The Model Law provides a number of ways to do this. The security agreement can provide the secured creditor with additional enforcement options, as long as they are not in conflict with the Model Law (ML art. 72(1)(b)).

303. Other laws of the enacting State can also have an impact on a secured creditor's enforcement options. They may provide additional options (ML art. 72(1)(b), for example, by allowing the secured creditor to sell the grantor's business in its entirety) or may limit or restrict the enforcement of a security right against certain persons or assets (for example, the insolvency law of the enacting State may impose a temporary stay of enforcement, see generally section I.C.5).

Out-of-court enforcement

304. A secured creditor can exercise its post-default rights by applying to the court or other authority specified by the enacting State. However, a secured creditor does not have to go to court and can instead enforce the security right itself (ML art. 73(1)). This may be a significant change in many jurisdictions. Out-of-court enforcement can make it possible for a secured creditor to recover what it is owed more quickly and more efficiently. However, the Model Law imposes conditions on how a secured creditor can undertake out-of-court enforcement to minimize the risk of misuse (ML arts. 77-80).

Different methods of enforcing a security right

305. The Model Law provides a secured creditor with a number of ways to enforce its security right. For example, a secured creditor can:

- Sell the encumbered asset and recover what it is owed from the proceeds
- Lease or license the encumbered asset and recover what it is owed from the rent or royalty payments, or
- Acquire the encumbered asset in total or partial satisfaction of the amount due

306. A secured creditor's choice of how to enforce will depend on a number of factors, including the type of asset and commercial circumstances. If the encumbered asset is a tangible asset, the most common choice will be for the secured creditor to take possession and then dispose of the asset, typically by sale. If the encumbered asset is an intangible asset, the secured creditor can also dispose of the asset, but it may have other options. For example, if the encumbered asset is a receivable, the secured creditor can collect payment of the receivable directly from the debtor of the receivable (ML art. 82, see section II.I.4 and example 29), which may realize more value than selling the receivable. If the encumbered asset is a bank account with respect to which the secured creditor has entered into a control agreement providing that the deposit-taking institution will follow instructions from the secured creditor regarding payment of funds or with respect to which the secured creditor itself is the deposit-taking institution, the secured creditor can withdraw the balance credited to the account and use it to pay the secured obligation (ML art. 82(1) and (4)).

307. A secured creditor must exercise its enforcement rights under the Model Law in good faith and in a commercially reasonable manner, whichever enforcement option it chooses (ML art. 4).

3. A preliminary step – taking possession of the encumbered asset

Example 28: Company X has a delivery business. Bank Y makes a loan to Company X. Company X gives Bank Y a security right in its vans to secure the loan. Bank Y registers a notice in the Registry and Company X retains possession of the vans. Later, Company X defaults on the loan. Bank Y wants to enforce its security right.

308. In example 28, the first thing that Bank Y needs to do to enforce its security right is to take possession of the vans. Bank Y is entitled to take possession of the vans, subject to the rights of another person with a superior right to possession (ML art. 77(1)). Bank Y would not be able to take possession if a higher-ranking secured creditor is in possession of the vans (ML art. 77(4)).

309. One option for Bank Y is to apply to a court to obtain possession. A court order will allow Bank Y to seize the vans even if Company X objects. Court proceedings can be an effective option if the grantor is not prepared to surrender the assets. However, this approach could lead to delays and pose problems, particularly if the encumbered assets are perishable or declining rapidly in value.

310. For this reason, Bank Y is likely to prefer to obtain possession of the vans itself, without applying to a court or other authority. To take possession itself, however, Bank Y needs to satisfy three conditions set out below (ML art. 77(2)). These conditions aim to balance the rights of the secured creditor and the grantor and to protect the public interest by ensuring that the process of taking possession is conducted in a lawful and peaceful manner.

- Company X needs to consent in writing. This consent will usually be included in the security agreement but can be given separately and later.
- Bank Y needs to notify Company X (and any other person in possession of the vans) in advance that Company X is in default and that Bank Y intends to take possession of the vans. However, the secured creditor does not need to do this if the encumbered asset is perishable or might rapidly decline in value (ML art. 77(3)).
- Bank Y can only take possession of the vans if the person in possession of the vans does not object when Bank Y attempts to take possession. If that person objects, Bank Y will have to apply to a court to obtain possession.

311. A secured creditor that has a security right in more than one asset is entitled to seize all of the assets in order to enforce its security right. However, if the secured creditor takes possession of more than one asset when the value of only one of the assets would be sufficient to satisfy the secured obligation, the secured creditor may be in breach of its obligation to exercise its rights in good faith and in a commercially reasonable manner (ML art. 4). This may make the secured creditor liable for damages or other consequences under other laws of the enacting State.

4. *Methods of enforcement*

Sale of the encumbered asset

312. Once Bank Y in example 28 has obtained possession of the vans, it will want to realize their value to recover what it is owed as quickly as possible. In most cases, Bank Y will want to sell the vans to recover what it is owed from the sale proceeds. If the encumbered asset is an intangible asset, the secured creditor will not be able to obtain possession of the asset but may similarly want to sell the asset.

313. One option would be for Bank Y to apply to a court to conduct the sale. The sale would then need to be in accordance with the rules specified by the enacting State (ML art. 78(2)). While a court-supervised sale has its merits, it might not always be appropriate as it might not yield enough proceeds to pay what is owed to the secured creditor.

314. Alternatively, Bank Y can sell the vans itself without applying to a court (ML art. 78(1)). The Model Law allows Bank Y to manage the method, manner, time, place and other aspects of the sale, including whether to sell the vans individually or together (ML art. 78(3)) subject to the requirements set out below.

315. Before Bank Y can sell any of the vans itself, it must give a notice to the following persons of its intention to go ahead with the sale (ML art. 78(4)).

- The grantor (Company X) and the debtor (if different to Company X)
- Any person with a right in any of the vans that had informed Bank Y of its right in writing before Bank Y notified Company X
- Any other secured creditor that registered a competing security right in any of the vans before Bank Y notified Company X, and
- Any other secured creditor that was in possession of any of the vans when Bank Y took possession

316. Bank Y must give a notice to those persons in advance of the sale (the time period is specified by the enacting State). A sample template of the notice is available in annex IX. The notice must contain the following information (ML art. 78(5)).

- A description of the vans
- A statement of the amount that needs to be paid to Bank Y to satisfy the secured obligation (including interest and reasonable enforcement costs)
- A statement that the grantor (Company X), any other person with a right in any of the vans or the debtor (if different to Company X) may terminate the sale by paying the amount owing in full, including reasonable enforcement costs (ML art. 75), and
- The date after which the vans will be sold or, in the case of a public sale, the time, place and manner of the proposed sale

317. An advance notice enables the recipients to verify whether the sale will take place under commercially reasonable conditions. If this is not the case, or if the secured creditor otherwise fails to satisfy the notice and other requirements of the Model Law, the secured creditor may be liable for any damage caused to the grantor or other concerned persons by the breach of its obligations. However, the validity of the sale cannot be challenged, unless the buyer of the encumbered asset was aware that the sale materially prejudiced the rights of the grantor or those concerned (ML art. 81(5)).

Lease or licence of the encumbered asset

318. It may not always be possible or desirable for a secured creditor to recover what it is owed by selling the encumbered asset. For example, there may not be a suitable secondary market for the asset and it might not be possible to find a buyer by other means, which would result in a sale of the encumbered asset that would not yield a suitable price. In that case, Bank Y in example 28 may instead decide to lease the vans and apply the rental payments towards the amount due (ML art. 78(1)). To do this, Bank Y must follow the same procedure required for the sale of the encumbered asset (ML art. 78(4)-(7)).

Acquisition of the encumbered asset in satisfaction of the secured obligation

319. In example 28, Bank Y can offer to acquire the vans itself, either in full or in partial satisfaction of what it is owed (ML art. 80(1)). The advantage of this method is that Bank Y could acquire ownership of the vans and dispose of them

freely later if it wishes to do so. Company X can also request Bank Y to make a proposal to acquire the vans (ML art. 80(6)).

320. This enforcement option is subject to procedural safeguards similar to those that apply to a sale of the encumbered asset. Bank Y's proposal to acquire the vans must be in writing and sent to the same persons that a secured creditor must send advance notice of the sale of an encumbered asset to (ML art. 80(2)).

321. Bank Y's proposal must contain the following information (ML art. 80(3)).

- A statement of the amount required to satisfy the secured obligation (including interest and reasonable enforcement costs) at the time of the proposal
- A description of the vans as the encumbered assets
- Whether Bank Y intends to acquire the vans in full satisfaction of the secured obligation or only in partial satisfaction
- A statement that Company X, any other person with a right in any of the vans, or the debtor (if different to Company X) may terminate the acquisition by paying the amount owing in full, including reasonable enforcement costs, and
- The date after which Bank Y will acquire the vans

322. A template for proposing the acquisition of the encumbered asset is available in annex X.

323. The conditions under which Bank Y will acquire the vans differ depending on whether it proposes to acquire them in full or in partial satisfaction of Company X's obligation. If Bank Y proposes to acquire the vans in full satisfaction of what it is owed, it will acquire the vans when the time period specified by the enacting State expires, unless one of the recipients of the proposal objects in writing before the expiry of that period (ML art. 80(4)). If Bank Y proposes to acquire the vans in partial satisfaction of what it is owed, it will only acquire the vans if all recipients of the proposal consent in writing before the expiry of the time period specified by the enacting State (ML art. 80(5)). If there is an objection from any of the recipients in the former case or if the consent of all the recipients is not obtained in the latter case, Bank Y will need to use a different enforcement method.

Collection of payment from third-party obligors

324. If the encumbered asset is a receivable, a negotiable instrument or a bank account, a secured creditor can enforce its security right by collecting payment

directly from the debtor of the receivable, the obligor under the negotiable instrument or the deposit-taking institution (ML art. 82).

Example 29: Company X sells household appliances to home developers. Many of its sales are on credit, with developers paying for the appliances over time. Company X needs operating funds from time to time to pay its expenses. Bank Y provides Company X with a line of credit, under which Company X can draw down a loan when it needs money. Bank Y takes security over all of Company X's existing and future receivables to secure the line of credit. Company X defaults. Bank Y wants to enforce its security right in the receivables.

325. In example 29, rather than selling the receivables, Bank Y can collect payment directly from Company X's customers and apply the money collected to satisfy the secured obligation. Bank Y should be aware that its right to collect payment is subject to the provisions of the Model Law that provide protection to the debtors of the receivables (ML arts. 61-67, see section II.A.6 and examples 10 and 11).

326. The provisions of the Model Law that otherwise apply to the enforcement of a security right (ML arts. 72-82) do not apply to outright transfers of receivables (ML art. 1(2)). Rather, an outright transferee of a receivable is entitled to collect the receivable at any time after payment becomes due (ML art. 83). This is because there is no secured obligation. The outright transferee is entitled to keep whatever it collects regardless of the amount that it paid for the receivable and does not need to return to the transferor any amount collected in excess of the amount it paid for the receivable. In turn, the outright transferee of a receivable bears the risk that it might not be able to collect the face value of the receivable (see section II.A.6 and example 10).

5. Right of the grantor and affected persons to terminate an enforcement process

Example 30: Bank Y makes a loan to Company X and takes security over Company X's printing press to secure the loan. Bank Z also makes a loan to Company X but does not take security over any of Company X's assets.

Later, Company X defaults. Bank Y takes possession of the printing press and plans to sell it through a public auction. Bank Z believes that its prospects of being paid are greater if Company X continues its business with the printing press. For this reason, Bank Z is willing to make an additional loan to Company X so that it can repay the loan to Bank Y and get the printing press back.

327. The grantor, any other person with a right in the encumbered asset, or the debtor can terminate an enforcement process by paying the secured creditor what it is owed, including any reasonable enforcement costs (ML art. 75(1)). They can do this at any time before the secured creditor has committed to sell or otherwise dispose of the encumbered asset or before the enforcement process is completed, whichever is earlier (ML art. 75(2)).

328. In example 30, Bank Z, as an unsecured creditor of Company X, cannot terminate the enforcement process itself. However, by advancing funds to Company X and arranging for Company X to use the funds to pay Bank Y the amount owing plus any reasonable enforcement costs (for example, costs that Bank Y may have incurred to repossess and store the printing press), Bank Z can indirectly terminate the enforcement process. This needs to be done before Bank Y enters into an agreement with a third party to sell the printing press.

6. Higher-ranking secured creditor's right to take over an enforcement process

Example 31: Ms. X runs a restaurant and obtains loans from Bank Y and Bank Z. The loan from Bank Y is due for repayment six months after the loan from Bank Z is due. To secure the loans, both Bank Y and Bank Z take security over Ms. X's kitchen appliances, but Bank Y registers its notice in the Registry before Bank Z does. Ms. X does not repay Bank Z's loan when it is due. At that time, Bank Y's loan is not yet due.

329. In example 31, Ms. X is in default under the loan agreement with Bank Z, but not in default under its loan agreement with Bank Y, because repayment is not yet due. However, Bank Z's security right does not have priority over Bank Y's security right because Bank Z registered later.

330. Bank Z can enforce its security right even though it is not the highest-ranking secured creditor. However, Bank Y, as the higher-ranking secured creditor, can take over the enforcement process at any time before the enforcement is completed (ML art. 76).

331. Even though Bank Y can take over the enforcement process, it cannot use the enforcement proceeds to repay what Ms. X owes it, because its loan is not yet due. A prudent secured creditor, when listing the events that would constitute default in the security agreement, should include the situation where a third party starts to enforce a claim against the encumbered asset to avoid finding itself in this position (see section II.D.3).

7. Distribution of the proceeds of a disposition of an encumbered asset

Example 32: Bank Y's security agreement with Ms. X in example 31 states that Ms. X is in default if any other secured creditor starts to enforce against the kitchen appliances. Bank Y enforces its security right and sells the kitchen appliances to Ms. V for ¥150,000. Bank Y's loan amount to Ms. X was ¥100,000. Bank Y is owed ¥5,000 in unpaid interest. Bank Y also incurred ¥10,000 in enforcement costs. Bank Z is owed ¥50,000.

332. A secured creditor that enforces its security right by selling, leasing or licensing the encumbered asset itself can only retain from the proceeds of such disposition what it is owed plus reasonable enforcement costs (ML art. 79(2)(a)). If there is a surplus, the secured creditor must pay the surplus to any lower-ranking competing claimant that had notified the secured creditor of its claim and the amount (ML art.79(2)(b)). If any balance remains, the secured creditor must pay that balance to the grantor (ML art.79(2)(b)). If the secured creditor had instead applied to the court or other authority specified by the enacting State, the distribution of the proceeds would be determined by the rules specified by that State and in accordance with the priority rules of the Model Law (ML art. 79(1), see part II.G).

333. In example 32, Bank Y enforces its security right by selling the kitchen appliances without applying to a court. In this case, Bank Y is responsible for distributing the proceeds. Bank Y can retain ¥10,000 to cover its enforcement costs, and ¥105,000 to repay the loan amount plus interest. Bank Y then needs to pay the remaining ¥35,000 to Bank Z. Alternatively, Bank Y can pay ¥35,000 to the competent judicial or other authority or a public deposit fund specified by the enacting State for distribution in accordance with the priority rules of the Model Law (ML art. 79(2)(c)). In either case, as Ms. X still owes ¥ 15,000 to Bank Z, Bank Z can seek the outstanding amount from Ms. X as an unsecured creditor (ML art. 79(3)).

8. Rights of a buyer of an encumbered asset

334. In example 32, Ms. V purchased the encumbered asset in an enforcement sale conducted by Bank Y. In that case, Ms. V will acquire the kitchen appliances free of any security rights, unless there is a security right in the kitchen appliances that has priority over Bank Y's security right (ML art. 81(3)). A lower-ranking competing claimant (for example, Bank Z) can no longer claim any right in the kitchen appliances after they have been sold to Ms. V.

335. A buyer in an enforcement sale conducted by the secured creditor should therefore determine whether there is any competing secured creditor that might have

priority over the enforcing secured creditor. In example 32, if Bank Y did not take over the enforcement and instead Bank Z had sold the kitchen appliances to Ms. V, Ms. V would obtain the appliances free of Bank Z's security right. However, Ms. V's right in the appliance would be subject to Bank Y's security right, because Bank Y has priority over Bank Z. For this reason, a lower-ranking secured creditor will rarely dispose of encumbered assets itself, since a buyer in an enforcement sale is unlikely to take the risk of purchasing an asset that is still subject to another security right. A lower-ranking secured creditor may, however, still decide to do so, when it is sure that the proceeds of the sale will be enough to pay the higher-ranking secured creditor what that secured creditor is owed and to also recover what it is owed.

J. Transition to the Model Law

1. General

336. The Model Law contains rules that determine its effect on transactions that were entered into before the Model Law came into force. A creditor involved in such a transaction needs to understand the effect that the entry into force of the Model Law has on its rights arising from those transactions. A creditor will also need to ensure that its rights continue to be effective under the Model Law. This part provides a general overview of the rules in the Model Law that address these issues.

2. *The Model Law applies to prior security rights*

337. Before the entry into force of the Model Law, parties to a transaction may have agreed to create a right over a movable asset to secure an obligation. If that right falls within the definition of a "security right" under the Model Law (see section I.B.2) and the Model Law would have applied to that right had the Model Law been in force when the right was created (see sections I.B.3 and I.B.4), then that right is a "prior security right" under the Model Law and the Model Law will apply to it (for the definition, ML art. 102(1)(b)).

338. This is the case even if the prior security right was not regarded as a security right under prior law (for the definition, ML art. 102(1)(a)). For example, a sale on retention-of-title terms that is entered into before the Model Law came into force will give rise to a prior security right, even if the seller's right under the transaction was not considered to be a security right under prior law.

3. *Situations where the prior law may still apply*

339. There are, however, a limited number of situations where the prior law may still apply.

340. First, the prior law applies to any matter that was the subject of proceedings brought before a court or arbitral tribunal before the Model Law came into force (ML art. 103(1)). If a secured creditor had begun to enforce a prior security right before the Model Law came into force, however, it can continue to enforce under the prior law or instead choose to enforce under the Model Law (ML art. 103(2)). A secured creditor may decide that it is more advantageous to proceed under the enforcement rules of the Model Law (see part II.I).

341. Second, the prior law determines whether a prior security right was properly created (ML art. 104(1)). There may be instances where the prior security right was effectively created under the prior law but does not meet the creation requirements of the Model Law (ML art. 6). In that case, the prior security right will remain effective between the parties (ML art. 104(2)).

342. Third, the prior law determines the priority of a prior security right as against the rights of competing claimants, if: (i) all the competing rights arose before the entry into force of the Model Law; and (ii) their priority status has not changed since the entry into force of the Model Law (ML art. 106).

4. *How to preserve the third-party effectiveness of a prior security right*

343. The third-party effectiveness requirements of the Model Law also apply to a secured creditor with a prior security right (ML art. 102). However, if the prior security right was effective against third parties under the prior law, it continues to be effective against third parties after the Model Law comes into force, but only for the limited time period specified by the enacting State (ML art. 105(1)(b)). If that time period is longer than the period for which the prior security right would have remained effective against third parties under the prior law, third-party effectiveness continues only until it would have ceased under the prior law (ML art. 105(1)(a)).

344. To preserve the third-party effectiveness of a prior security right, a secured creditor needs to satisfy the third-party effectiveness requirements of the Model Law before the expiry of the time period specified by the enacting State. The most usual way to do this is to register a notice in the Registry. If the secured creditor does this before the third-party effectiveness ceases, its prior security right will continue to be effective against third parties from the time it was originally made effective against third parties under the prior law (ML art. 105(2)). Otherwise, its prior security right will only be effective against third parties from the time when the secured creditor satisfies the requirements of the Model Law (ML art. 105(3)).

5. An example of how the transition rules of the Model Law work

Example 33: A State enacted a new law based on the Model Law in 2018. The law entered into force on 1 January 2019.

Company X has a printing business. Its main asset is its printing press. In 2014, Bank Y made a loan to Company X and took security over Company X's printing press. Under the law in effect at that time, a security right in a tangible asset that remains in the possession of a grantor can be made effective against third parties indefinitely by attaching a mark to the asset that states that there is a security right in the asset. Bank Y attached a mark to the printing press.

Company X wanted to expand its operations to include delivery services. In August 2014, Company Z provided funding to Company X to purchase three vans. Company Z took security over the vans. Under the law in effect at that time, Company Z's security right in the vans can be made effective against third parties by registering a notation in the Motor Vehicles Registry. Company Z registered the notation in the Motor Vehicles Registry on 1 August 2015. The notation expires on 31 July 2019.

The new law does not recognize attaching a mark on the encumbered asset or a notation in the Motor Vehicles Registry as a method of achieving third-party effectiveness of a security right. Instead, a secured creditor with a prior security right is given one year after the new law comes into force to comply with the third-party effectiveness requirements of the new law, which includes registering a notice in the Registry.

345. In example 33, if Bank Y's security right in the printing press and Company Z's security right in the vans were properly created under the law in effect at the time, they remain effective between the parties after the Model Law comes into force, whether or not the parties satisfied the creation requirements of the Model Law. Under the Model Law, both security rights are prior security rights as they fall within the definition of a security right in the Model Law and the Model Law would have applied to them if it had been in force when they were created.

346. Bank Y's security right in the printing press would have remained effective against third parties indefinitely under the prior law. However, the third-party effectiveness will lapse on 31 December 2019 if Bank Y does nothing, as the new law gave Bank Y one year to comply with its third-party effectiveness requirements. If Bank Y wants to preserve the third-party effectiveness of its security right beyond 31 December 2019, it needs to register a notice in the Registry before that date.

347. The third-party effectiveness of Company Z's security right in the vans would expire on 31 July 2019 under the prior law. If Company Z wants to preserve the

third-party effectiveness of its security right in the vans beyond 31 July 2019, it needs to register a notice in the Registry before that date.

348. If Bank Y and Company Z respectively register their notices in the Registry before the above-mentioned dates, their security rights will continue to be effective against third parties from the time they were initially made effective against third parties under the prior law. If they do not register the notices before the above-mentioned dates, their security right will only be effective against third parties from the time the respective notices are registered, which means that they may rank behind another secured creditor that registered a notice earlier.

349. If Bank Y or Company Z started to enforce its security right in 2018 and the process was not completed by 31 December 2018, it can continue to enforce under the prior law or instead proceed with the enforcement under the Model Law. If Bank Y or Company Z only starts to enforce its security right after 1 January 2019, it will need to do so in accordance with the Model Law.

K. Issues arising from cross-border transactions

1. General

350. Much of this Guide assumes transactions where all relevant elements, including the parties and the encumbered assets, are located in a single State that has enacted the Model Law. This means that the Model Law would apply to those transactions.

351. If a transaction is connected to more than one State (a “cross-border transaction”), however, matters become more complicated. The laws of the relevant States are unlikely to be identical. As a result, the rules governing a cross-border transaction will depend on which State’s law applies. This means that the parties need to determine which State’s law applies to the following issues to structure and administer their transaction properly.

- The creation of the security right
- The third-party effectiveness of the security right
- The priority of the security right as against competing claimants, and
- The enforcement of the security right

352. The rules that determine which State’s law governs a cross-border transaction are known as “conflict-of-laws rules”. Each State has its own conflict-of-laws rules, and those rules can vary significantly. In a dispute involving a secured transaction, the court will apply the conflict-of-laws rules of its own State to determine which

State's law it will apply to the transaction. This is also the case for insolvency proceedings. For the sake of simplicity, this part assumes that all the relevant States have adopted the conflict-of-law rules of the Model Law.

353. Because conflict-of-law questions can be complex, parties entering into a cross-border transaction or anticipating that cross-border issues could arise in their transaction should obtain legal advice on which State's laws will apply to their transaction.

2. An overview of the conflict-of-laws rules of the Model Law

Creation

354. The law that determines whether a security right has been effectively created depends on whether the asset in question is tangible or intangible. For a tangible asset, the applicable law is the law of the State where the asset is located (ML art. 85). For an intangible asset, it is the law of the State where the grantor is located (ML art. 86). In both instances, the relevant location is the location at the time the security right is intended to be created (ML art. 91(1)(a)). The State where the secured creditor is located is irrelevant for this purpose as well as for third-party effectiveness, priority and enforcement of a security right.

Third-party effectiveness and priority

355. Similarly, the law that determines whether a security right is effective against third parties, and the priority of that security right as against competing claimants, depends on whether the encumbered asset is tangible or intangible. For a tangible asset, the applicable law is the law of the State where the asset is located (ML art. 85). For an intangible asset, it is the law of the State where the grantor is located (ML art. 86).

356. The relevant location for third-party effectiveness and priority issues is the location of the encumbered asset or the grantor when the issue arises (ML art. 91(1)(b)). Since assets can be moved and grantors can change their location from one State to another, the law applicable to third-party effectiveness and priority can change over the course of a transaction. A secured creditor should regularly monitor the location of the encumbered asset and the grantor to ensure that the third-party effectiveness of its security right is maintained and that its priority as against competing claimants does not change solely as a result of a change in the applicable law. In particular, if the applicable law changes as a result of a change in the location of the encumbered asset or the grantor, the secured creditor may need

to take protective action, such as registering a notice in another State's Registry (ML art. 23).

Enforcement

357. The law that determines the enforcement process depends on whether the encumbered asset is tangible or intangible. For a tangible asset, the applicable law is the law of the State where the asset is located when the enforcement process starts (ML art. 88(a)). For an intangible asset, it is the law of the State where the grantor is located (ML art. 88(b)).

3. Conflict-of-laws rules specific to certain types of assets

358. The explanation in section 2 is a very simplified overview and does not address every issue for every type of asset. For example, the law that determines the creation, third-party effectiveness, priority and enforcement of a security right in a bank account will usually be the law of the State where the bank account is maintained (ML art. 97(1), option A). The Model Law also provides special conflict-of-laws rules for security rights in the following types of assets.

- Tangible assets covered by a negotiable document (ML art. 85(2))
- Tangible assets of a type ordinarily used in more than one State (ML art. 85(3))
- Goods in transit (ML art. 85(4))
- Intellectual property (ML art. 99), and
- Non-intermediated securities (ML art. 100)

359. With respect to a security right in a receivable, a negotiable instrument or a negotiable document, which all involve a third-party obligor (the debtor of the receivable, the obligor under the negotiable instrument or the issuer of a negotiable document), the parties would also need to determine which State's law applies to the rights and obligations between the secured creditor and the third-party obligor. The law that determines those issues is the law that governs the rights and obligations between the grantor and the third-party obligor (ML art. 96(a)). The same law also determines the conditions under which the security right may be invoked against the third-party obligor and whether the obligations of the third-party obligor have been discharged (ML art. 96(b) and (c)).

4. Examples of how the conflict-of-laws rules of the Model Law work

Example 34: Company X is a distributor of computers. It administers its business from an office located in State A. Company X offers computers for sale in stores located in State A and State B. Bank Y, located in State C, makes a loan to Company X. Bank Y wants to take security over the computers held as inventory in all of Company X's stores.

360. In example 34, the encumbered assets (the computers) are tangible assets. This means that the law applicable to the creation and third-party effectiveness of Bank Y's security right is the law of the State where the computers are located. For Bank Y's security right to be effective as against Company X and third parties, Bank Y needs to satisfy the requirements of the law of State A with respect to the computers in located in State A, and the requirements of the law of State B with respect to the computers located in State B. The law of the State where the computers are located will apply to determine the priority of Bank Y's security right as against competing claimants in the computers.

Example 35: Company X is a distributor of computers. It administers its business from an office located in State A. Company X sells computers on credit from stores in State A and State B to customers located in States A and B as well as in other States. Bank Y, located in State C, makes a loan to Company X. Bank Y wants to take security over all Company X's present and future receivables.

361. In example 35, the encumbered assets (receivables) are intangible assets. This means that the law applicable to the creation and third-party effectiveness of Bank Y's security right is the law of the State where the grantor (Company X) is located. For the purposes of the conflict-of-law rules, the location of the grantor is the State where it has its place of business (ML art. 90(a)). However, in this example, the grantor has places of business in two States (States A and B). If the grantor has places of business in more than one State, its location is the State where its central administration is exercised (State A) (ML art. 90(b)). This means that Bank Y needs to fulfil the requirements of the law of State A for its security right in the receivables to be effective as against Company X and third parties. This is regardless of the fact that the customers of Company X may be located in States other than State A. The law of State A will also apply to determine the priority of Bank Y's security right as against competing claimants in the receivables.

Example 36: Company X has a bank account with a bank located in State A and a bank account with a bank located in State B. Company X deposits collections from its receivables to these accounts. Bank Y, located in State C, makes a loan to Company X. Bank Y wants to take security over both bank accounts.

362. In example 36, if State C implemented option A of article 97 of the Model Law, the law applicable to the creation and third-party effectiveness of Bank Y's security right in the bank accounts is the law of the State where the bank accounts are maintained. Bank Y will need to satisfy the requirements of the law of State A (for the bank account maintained in State A) and the law of State B (for the bank account maintained in State B) for its security right in both bank accounts to be recognized in State C as effective as against Company X and third parties.

5. *Effectiveness of choice of law and choice of forum clauses*

363. Parties are free to choose the law that will apply to issues relating to the obligations between the secured creditor and the grantor (ML art. 84). In the absence of a choice by the parties, the law governing the security agreement will apply. However, the conflict-of-laws rules of the Model Law on the law applicable to the creation, third-party effectiveness, priority and enforcement of a security right are mandatory (ML art. 3(1)). Parties cannot change the law that applies to these issues by choosing a different State's law in their agreement.

364. Parties may seek to control where court proceedings take place by inserting a "choice-of-forum" clause that purports to grant exclusive jurisdiction to the courts of a chosen State over any disputes arising from their security agreement. Similarly, parties may include an arbitration clause referring any dispute to arbitration. Although a choice-of-forum or arbitration clause may be effective between the secured creditor and the grantor, it is unlikely to displace the jurisdiction that may be exercised by a court in another State if the proceeding in that State involves the rights of third parties or if insolvency proceedings are commenced by or against the grantor in that State. The conflict-of-laws rules of the Model Law will not prevent a court from applying any overriding mandatory law of the forum that apply irrespective of the law applicable under the Model Law (ML art. 93(1)). However, a court is not permitted to displace the provisions of the Model Law that determine the law applicable to the third-party effectiveness and priority of a security right (ML art. 93(6)).

III. The interaction between the Model Law and the prudential regulatory framework

A. Introduction

365. This chapter is addressed primarily to financial institutions that are subject to prudential regulation and supervision (“regulated financial institutions”). Typically, banks and other financial institutions that receive repayable funds, or deposits, from the public to extend loans would fall under this category. This chapter may also provide useful guidance to national authorities exercising prudential regulatory powers and supervisory functions (“regulatory authorities”).

366. The purposes of this chapter are to assist regulated financial institutions to benefit fully from the Model Law and to emphasize the need for closer coordination between the Model Law and the national prudential regulatory framework. This coordination should be understood in the broader context of interaction of the Model Law with other domestic laws (see section I.C.5). This chapter does not address core policy choices underlying the prudential regulatory framework, whether national or international.

367. Capital adequacy standards, also referred to as capital requirements, for regulated financial institutions are a key component of a State’s prudential regulatory framework. They typically require regulated financial institutions to control their exposure to various risks and to maintain adequate capital to absorb losses, taking into account both the soundness of the individual institutions and the stability of the financial system as a whole. Capital adequacy standards typically include specific requirements to cover operational risk, market risk and credit risk, with the focus on credit risk.

368. Capital requirements are primarily concerned with the absorption of unexpected losses.¹ For this purpose, they define the minimum amount of capital (referred to as “regulatory capital”) that regulated financial institutions are required to maintain at any point in time in relation to their exposure to risks. Regulatory capital requirements are expressed as a ratio of: (i) the financial institution’s own funds, primarily composed of shareholders’ equity and long-term subordinated debt; and (ii) the risk-weighted assets of the financial institution. This means that the required amount of capital is not fixed in absolute terms but is set relative to both the balance sheet size of the regulated financial institution and the riskiness of its assets. In practice, for every financing transaction, such as a loan, regulated financial institutions calculate a capital charge that reflects the level of risk of that transaction (in particular, the credit risk). Loans with a higher level of risk are subject to higher capital charges. For regulated financial institutions, this means that when the exposure is riskier, a greater amount of regulatory capital is required.

369. National statutory or regulatory laws defining capital requirements determine the risk weights of different classes of assets and set the capital adequacy ratios that regulated financial institutions must meet. Capital requirements do not prevent regulated financial institutions from extending loans. If a regulated financial institution extends a loan, it must either increase the amount of its own funds or reduce its exposure to credit risk, for instance, through the adoption of a risk mitigation technique.

370. In addition to regulatory capital, national regulatory authorities prescribe requirements to manage expected losses. These rules, often referred to as provisioning requirements or loan loss provisioning requirements, establish procedures to assess and monitor expected losses associated with a given credit facility in order to set aside reserves, or allowances. These requirements prescribe categories for the classification of loans depending on whether they are performing, underperforming, or non-performing and ensure that allowances increase as the credit facility deteriorates. Regulated financial institutions are typically required to assess, in a forward-looking manner, the likelihood of incurring losses on each loan to determine the appropriate regulatory category and to set aside the corresponding provisions. In this process, regulated financial institutions may take into account the loss absorption capacity provided by collateral.

¹ Expected loss refers to a loss that is statistically expected to occur on an exposure within a given period, for example, one year from the loan. Unexpected loss refers to a loss that is greater than what is expected from a statistical standpoint within a given period. Expected and unexpected losses are typically estimated through models based on historical observations to determine frequency and impact of relevant credit events.

371. International efforts have been made to ensure that prudential regulation of financial institutions is coordinated and respects international minimum standards. The Basel Committee on Banking Supervision (BCBS) is one of the organizations entrusted with the task of establishing international standards on the capital requirements contained in the Basel Capital Accords. In addition, there are international accounting or financial reporting standards that may be applied in conjunction with prudential regulation.

372. Before the enactment of the Model Law, there may not have been sufficient legal certainty for regulated financial institutions to take into account security rights in movable assets when calculating loan loss provisioning and regulatory capital. The Model Law (coupled with the Registry) provides the necessary legal certainty, predictability, and transparency for the sound management of credit risk with respect to expected and unexpected losses. Through further coordination between the Model Law and prudential regulation, it might be permissible for regulated financial institutions to take into account security rights in movable assets when determining provisions and capital charges.

B. Key terminology

373. Terminology used by regulated financial institutions, national regulatory authorities and the BCBS may differ from that used in the Model Law. As this chapter is addressed primarily to regulated financial institutions, this section illustrates how some of the terms are used in this chapter.

Collateralized transactions	<p>One of the techniques that regulated financial institutions may adopt to mitigate credit risk</p> <p>They encompass any consensual arrangement under which the exposure to credit risk is covered, fully or partially, by a right in an encumbered asset (including a security right under the Model Law).</p>
Credit risk mitigation	<p>Various techniques, such as collateralized transactions, rights of set-off, and guarantees, used by regulated financial institutions to reduce their exposure to credit risk</p> <p>When specific requisites are met, credit risk mitigation techniques could be taken into account in the calculation of capital charges.</p>
Eligible collateral	<p>Assets that are encumbered by a security right and may be taken into account for the calculation of capital charges, subject to certain conditions being met</p>

Eligible financial receivables	<p>Claims of less than or equal to one year (including debts arising from sale of goods or provision of services in commercial transactions and debts owed by non-affiliated parties not related to the sale of goods or services in a commercial transaction) that may be taken into account for the calculation of capital charges</p> <p>They do not encompass claims arising from securitizations or credit derivatives.</p>
Physical collateral	<p>Tangible movable assets such as machinery, raw materials and motor vehicles, with the exception of commodities and aircraft (which typically belong to the category of specialized lending exposures)</p>
Specialized lending exposures	<p>Exposures with specific characteristics and subject to a different regime for calculating capital charges, including commodities finance and object finance</p>

C. Enhancing coordination between the Model Law and national prudential regulation

374. The primary objective of the Model Law is to increase access to credit at a reasonable cost, through the establishment of a modern secured transaction regime facilitating, among others, the creation and enforcement of security rights in movable assets. Under the Model Law, financial institutions may acquire a security right to reduce their exposure to credit risk, which should, in turn, enable them to extend more credit. The Model Law does so by covering a wide range of assets and permitting parties to tailor their arrangement to fit their needs and expectations (see part I.B).

375. National prudential regulation generally takes into account collateral in mitigating the credit exposures of financial institutions. However, the lack of coordination between capital requirements and the Model Law could inadvertently limit the incentives that regulated financial institutions have to extend credit secured by rights over certain movable assets. In addition, and as further illustrated in this chapter, certain movable assets, such as receivables, inventory, or equipment, might not necessarily qualify as eligible collateral. In these circumstances, loans would be treated as unsecured for prudential regulatory purposes.

General prerequisites

376. For a collateralized transaction to be recognized as an eligible credit risk mitigation for calculating capital requirements and potentially reducing capital charges, some requisites need to be met. In particular, following international standards on capital requirements, it is essential that there be legal certainty with respect to security rights and that they can be efficiently enforced upon default of the debtor.

377. Regulated financial institutions are usually required to demonstrate two pre-conditions with respect to any collateralized transaction. First, the security right must be the highest-ranking in priority apart from preferential claims. Chapter V of the Model Law provides a comprehensive and coherent set of priority rules which regulated financial institutions can rely on to identify and establish the priority of their security rights as against competing claimants (see part II.G). Furthermore, article 35 of the Model Law provides that the priority of a security right continues unimpaired in the insolvency of the grantor, except as otherwise provided under insolvency law of the enacting State. Second, the security right must be enforceable in a timely manner. Chapter VII of the Model Law provides rules to facilitate efficient and expeditious enforcement of a security right (including expeditious relief as provided in article 74, see part II.I). In short, the Model Law provides mechanisms under which regulated financial institutions can meet the general prerequisites in capital requirements for the calculation of capital charges.

378. Financial institutions are also required to develop sound internal procedures to control, monitor, and report any risk associated with the collateral including those that could potentially compromise the effectiveness of credit risk mitigation. Moreover, they are usually required to establish and document internal procedures for the expeditious enforcement of security rights. To this end, it is important for regulated financial institutions to become familiar with the relevant provisions of the Model Law, in particular, with the steps necessary to enforce their security right (see part II.I). They should also adopt policies to ensure that the priority of their security right is not undermined, for instance, by the inadvertent lapse of the effectiveness of a registration of a notice (see section II.E.8).

379. If a collateralized transaction involves connections with more than one State and thus may be governed by laws of more than one State, financial institutions would need to ensure that their security rights are adequately protected (mainly their priority and enforceability) under those laws. Provisions in chapter VIII of the Model Law provide clarity on the applicable law, which financial institutions can rely on (see part II.K).

Capital requirements

380. There are various methodologies to assess credit risk and to calculate corresponding capital charges. Under the standardized approach, risk weights are set out in national statutory or regulatory laws, which also list eligible collateral. Reflecting international standards, the list of eligible collateral typically includes only highly liquid assets, such as funds held in deposit accounts with the lending financial institution, gold, and intermediated securities. The rights of regulated financial institutions to reimbursement of their undertakings in the form of

commercial letters of credit might also reduce capital charges if certain conditions are met. Movable assets of businesses (such as receivables, inventory, agricultural products, and equipment) are, however, typically not included in the list of eligible collateral under the standardized approach. This means that they are not normally taken into account when capital charges are calculated, although they might be taken into account for provisioning purposes.

381. Subject to certain minimum conditions and disclosure requirements, regulated financial institutions may be permitted by national regulators to use more sophisticated methodologies. These methodologies are based on internal models and are commonly referred to as internal ratings-based (IRB) approaches. When authorized to use one of these approaches, regulated financial institutions would be able to rely on their own internal estimates of risk components in determining the capital requirement for a given exposure. The risk components include measures of the probability of default, loss given default, the exposure at default, and effective maturity. In some cases, regulated financial institutions are required to use a value established by national regulatory authorities, rather than an internal estimate for one or more of the risk components. Regulated financial institutions using these approaches are allowed to recognize additional forms of collateral, such as financial receivables and physical collateral, subject to certain conditions being met. For regulated financial institutions with approval to use their own estimated values of loss given default, the estimate must be grounded in historical recovery rates and must not solely be based on the collateral's estimated market value. IRB approaches tend to be applied by regulated financial institutions that are familiar with more sophisticated techniques for risk management and have sufficient and reliable historical data.

382. The process of regulated financial institution obtaining authorization to use IRB approaches is generally set out in national statutory or regulatory laws. In line with international standards, authorization requires a thorough supervisory examination of the risk-management practices of the regulated financial institution as well as scrutiny of the reliability of internal models. Furthermore, regulated financial institutions are required to implement sound internal procedures to assess and manage credit risk. Regulatory authorities may establish additional requirements to foster the soundness and the reliability of the models. Regulatory authorities may authorize or reject a request for authorization to use IRB approaches and may also withdraw any previous authorization.

Financial receivables and physical collateral as eligible collateral

383. When regulated financial institutions obtain authorization to use IRB approaches, they can take into account financial receivables and physical collateral for credit risk mitigation purposes. To do so, they would need to comply with several criteria set out in the capital requirements.

384. For financial receivables to be considered as eligible collateral, regulated financial institutions are typically required to:

- Have the right to collect or transfer the receivables without any consent of the debtor of the receivable (see ML arts. 59, 78, 82 and 83 and section II.I.4)
- Have a right to proceeds (see ML art. 10 and section II.A.7)
- Ensure that the security right in the receivables is effective against third parties
- Ensure that they have priority over competing claimants
- Establish lending policies determining which financial receivables should be taken into account when setting the amount of available credit
- Establish processes for collecting receivables in situations of distress, and
- Implement sound processes to manage the credit risk associated with receivables (for example, performing due diligence on the borrower and the industry, establishing mechanisms to set advance rates, adopting policies ensuring that the receivables are diversified and not unduly correlated with the borrower, and ensuring that the receivables are continuously monitored).

385. For physical collateral to be considered as eligible collateral, regulated financial institutions are typically required to:

- Demonstrate the existence of liquid markets to dispose of the physical collateral in a timely manner
- Ensure that transparent and publicly available prices are available for estimating the value of the physical collateral in case of default
- Have the highest-ranking priority in the physical collateral as well as its proceeds
- Include in the loan agreement a detailed description of the physical collateral and the right of the institution to inspect the collateral whenever deemed necessary
- Indicate the types of assets that would be accepted as physical collateral
- Establish internal credit policies for auditing and supervisory examination purposes, and
- Regularly monitor the physical collateral and periodically revalue it to take into account any deterioration or obsolescence.

386. In addition to the regulatory regime for different types of collateral, national regulatory authorities may authorize regulated financial institutions to classify certain loans as specialized lending exposures, which are subject to a different regime for the calculation of capital charges. For loans to be classified as specialized lending exposures, they should generally satisfy the following criteria.

- The lender should have a substantial degree of control over the assets and the income that they generate
- The exposure should be to a borrower which has the sole purpose of financing and/or operating the assets, and
- The primary source of repayment should be the income generated by the assets being financed, rather than by the independent capacity of the borrower

387. Specialized lending exposures are typically divided into different sub-classes. Among the sub-classes, commodities finance and object finance are particularly important in the context of secured transactions.

388. Commodities finance is generally understood as structured short-term lending secured by inventories or receivables of exchange-traded commodities (such as crude oil, metals, or crops). The loan will be repaid solely from the proceeds of the sale of the commodities rather than from other business activities of the borrower. Depending on the nature of the inventory and receivables, a transaction secured by inventory or receivables may be considered either as a corporate exposure, for which credit risk is mitigated through eligible physical collateral, or as a specialized lending exposure in the form of commodities finance.

389. Object finance refers to the financing of the acquisition of a high-value asset (for example, ships, aircraft, satellites, and railcars) where the repayment of the loan depends on the cash flows generated by the asset. The Model Law might not necessarily apply to security rights over such assets (ML art. 1(3)(e), see section II.E.12), for example, where security rights over such assets may be governed by the international legal framework established by the Convention on International Interests in Mobile Equipment (Cape Town Convention) and its Protocols, or by other domestic laws.

390. While coordination efforts between the Model Law and prudential regulation may result in reduced capital charges, that is not the sole purpose of coordination. It is also to promote sound risk management that is based on a thorough assessment of risks related to collateralized transactions. The result of such coordination informs the design of a legal and regulatory framework that incentivizes a prudent and inclusive credit environment.

Annexes

I. The Model Law and work by UNCITRAL in the area of secured transactions

UNCITRAL has prepared a number of instruments in the field of secured transactions aimed at enhancing the availability of credit and reducing its cost. These instruments may help readers to better understand the rules as well as the underlying policies and principles of the Model Law.

United Nations Convention on the Assignment of Receivables in International Trade (2001)	<ul style="list-style-type: none">• Provides uniform rules on the international assignment of receivables and assignment of international receivables with the aim of facilitating financing using receivables• Includes conflict-of-laws rules
Legislative Guide on Secured Transactions (2007)	<ul style="list-style-type: none">• Provides a broad policy framework for an effective and efficient secured transactions law• Includes commentary and legislative recommendations to assist States in their secured transactions law reform
Legislative Guide on Secured Transactions: Supplement on Security Rights in Intellectual Property (2010)	<ul style="list-style-type: none">• Provides guidance to facilitate the extension of secured credit to holders of intellectual property rights using those rights as collateral• Includes commentary and recommendations dealing specifically with security rights in intellectual property
Guide on the Implementation of a Security Rights Registry (2013)	<ul style="list-style-type: none">• Provides commentary and recommendations on the establishment and operation of an efficient and accessible security rights registry, with the aim of increasing the transparency and certainty of security rights

Model Law on Secured Transactions (2016)	<ul style="list-style-type: none">• Provides a comprehensive set of legislative provisions for enactment by States to address security rights in all types of movable assets• Includes Model Registry Provisions to address the registration of notices of security rights in a publicly accessible registry
Guide to Enactment of the Model Law (2017)	<ul style="list-style-type: none">• Provides guidance to States in their enactment of the Model Law• Explains briefly the thrust of each provision of the Model Law and its relationship with the corresponding recommendations of the Legislative Guide on Secured Transactions

II. Glossary

The following explains the key terms used in this Guide. It should be read in conjunction with article 2 of the Model Law, which provides the definition of some of those terms and forms the basis of the following explanations.

Term	What it broadly means
Acquisition security right (ML art. 2(b))	<p>A security right which secures credit provided to enable a person (the grantor) to acquire rights in an asset to the extent that the credit is used to finance the acquisition</p> <p><Examples></p> <ul style="list-style-type: none">• A security right in an asset to secure a loan, which is made to a buyer to enable its purchase of the asset to the extent that the credit was used for the purchase (see examples 6B and 6C)• A seller's right in an asset under a sale, which provides that the seller retains title to the asset until the buyer has paid the purchase price in full (see example 6A)• A lessor's rights in an asset that it leases to a lessee under a financial lease (see example 6D)
All-asset security right	<p>A security right over all present and future assets of the grantor (see example 5)</p>
Borrowing base	<p>A proportion of the value of assets provided as collateral on the basis of which the creditor is willing to loan (see example 20)</p>
Competing claimant (ML art. 2(e))	<p>A creditor of a grantor or other person with rights in an encumbered asset that may be in competition with the rights of a secured creditor in the same encumbered asset</p> <p>The term includes include an insolvency representative in insolvency proceedings in respect of the grantor.</p> <p><Examples></p> <ul style="list-style-type: none">• Another secured creditor with a security right in the same encumbered asset (see example 21)• A buyer or other transferee of the encumbered asset (see example 22)• A judgment creditor who has taken steps to acquire a right in the encumbered asset (see example 26)

**Debtor
(ML art. 2(h))**

A person who owes payment or other performance of the secured obligation

The debtor will usually be the person who grants a security right in its assets, in which case the debtor and the grantor will be the same person. If another person grants a security right in its assets to secure the obligation of the debtor, the debtor will be different from the grantor.

**Debtor of the receivable
(ML art. 2(i))**

A person that owes payment of a receivable that is subject to a security right (see examples 10, 11 and 29)

**Default
(ML art. 2(j))**

The failure of a debtor to pay or otherwise perform a secured obligation and any other event as agreed between the grantor and the secured creditor

<Examples>

- A material breach by the grantor of a provision in the security agreement
- The insolvency of the grantor
- A third party taking steps to seize or enforce against the encumbered asset (see example 31)
- The entry of a judgment against the grantor above a certain amount

**Encumbered asset
(ML art. 2(k))**

A movable asset that is provided to secure an obligation
The term is used in this Guide interchangeably with the term "collateral". The term includes a receivable that is transferred outright by agreement (see example 10).

<Examples>

- Inventory and receivables that a grantor provides to secure a revolving loan (see example 11)
- An equipment that a distributor sells on retention-of-title terms (see example 6A)
- A car that is being leased under a finance lease
- A licence to use intellectual property that the licensee has provided as security

**Equipment
(ML art. 2(l))**

A tangible asset other than inventory or consumer goods that is primarily used by a grantor in the operation of its business

<Examples>

- A printing press owned by a printing business
- A coffee machine leased by a coffee shop for its operation
- Credit card readers in a retail shop

**Future asset
(ML art. 2(n))**

A movable asset which does not yet exist, or which the grantor does not yet have rights in or the power to encumber, at the time the security agreement is entered into

<Examples>

- Cattle that the grantor purchases after the security agreement is entered into (see example 4)
- Products that the grantor manufactures after the security agreement is entered into
- Receivables that the grantor generates after the security agreement is entered into

**Grantor
(ML art. 2(o))**

A person who creates a security right in an asset to secure an obligation that it owes, or that is owed by another person

The term also includes a transferor of a receivable by agreement (see example 10) as well as a buyer or other transferee of an encumbered asset that acquires its rights subject to the security right (see examples 19 and 22).

<Examples>

- A buyer of equipment on retention-of-title terms (see example 6A)
- A lessee under a financial lease (see example 6D)
- A company that grants a security right over all of its inventory and receivables to secure a revolving loan (see example 11)

**Inventory
(ML art. 2(q))**

Tangible assets that are held for sale or lease in the ordinary course of business, including raw materials and work in process

<Examples>

- Paper used by a printing business to print brochures for its customers (see example 23)
- Products available for sale in a shop

**Movable asset
(ML art. 2(u))**

A tangible or intangible asset, which is not immovable property

<Examples>

- Inventory
- Equipment
- Receivables
- Money
- All types of intellectual property

**Priority
(ML art. 2(aa))**

The right of a person in an encumbered asset that ranks ahead of the right of a competing claimant

**Proceeds
(ML art. 2(bb))**

Anything that is received in respect of an encumbered asset

<Examples>

- Whatever is received upon the sale of the asset
- Insurance proceeds, if the asset is damaged, lost or destroyed
- Warranty claims, if the asset is defective
- Rent payments, if the asset is leased
- Royalty payments, if the asset is licensed
- Interest payments, if the asset is an interest-bearing debt claim
- Dividend payments, if the asset is shares in a company

The term also includes proceeds of proceeds. For instance, if the cash received upon the sale of the asset is used to buy an equipment, the equipment is also proceeds of the asset (see example 13).

**Receivable
(ML art. 2(dd))**

A right to payment of money

The term does not include a right to payment evidenced by a negotiable instrument, a right to payment of funds credited to a bank account or a right to payment under a non-intermediated security.

<Examples>

- Money owing to a plumber who has rendered an account to the customer but not been paid yet
- Money owing to a distribution business that sells assets to its customers on credit terms

**Secured creditor
(ML art. 2(ff))**

A person who has a security right
The term includes a transferee of a receivable by agreement. The term is used in this Guide to also refer to a prospective secured creditor, in other words, a person that intends to take security over a movable asset.

<Examples>

- A lender that obtains a security right in all of the assets of a company to secure a revolving loan
- A seller of equipment on retention-of-title terms (see example 6A)
- A lessor under a finance lease (see example 6D)

**Security agreement
(ML art. 2(jj))**

An agreement between a grantor and a secured creditor to create a security right, whether or not the parties call it a security agreement

<Examples>

- An agreement that creates a security right in an asset that the grantor owns to secure the payment of a loan (see annex IV)
- An agreement for the sale of a tangible asset with a retention-of-title clause (see annex V)
- An agreement for the transfer of a receivable, whether or not the transfer is for security purposes

**Security right
(ML art. 2(kk))**

A property right in a movable asset created by a security agreement that secures payment or other performance of an obligation

The term includes any right that serves a security purpose, whether or not the parties have called it a security right, and regardless of the type of asset, the status of the grantor or secured creditor, or the nature of the secured obligation. The term also includes the right of a transferee in a transfer of a receivable by agreement.

<Examples>

- The right of a creditor who obtains a security right in an asset to secure the performance of services under a contract
- The right of a creditor who takes possession of an asset to secure the payment of a loan
- The right of a seller of a tangible asset on retention-of-title terms (see example 6A)
- The right of a lessor under a finance lease (see example 6D)

III. Sample Diligence Questionnaire

A secured creditor will often begin its due diligence by asking the grantor to complete a questionnaire to obtain some essential information needed to protect its security right in the assets to be encumbered. The following provides a sample of such a questionnaire, which should not be understood as a standard or model. It asks for a wide range of information suitable for a relatively complex secured transaction. It should be adjusted to reflect the circumstances of each transaction. A simpler questionnaire may be used for a less complex transaction. It is also advisable to request similar information from other co-borrowers and guarantors.

To [*name of the secured creditor*],

The undersigned, [*name of the grantor*] (the “Company”) represents and warrants to you as follows:

1. General information relating to the Company

- (a) The name of the Company as it appears in its current organizational documents: [_____]
- (b) Identification number: [_____]
- (c) Tax identification number: [_____]
- (d) Jurisdiction of incorporation: [_____]
- (e) Other jurisdictions where the Company is duly qualified to conduct business: [_____]
- (f) All other names (including fictitious, trade and similar names) currently being used by the Company or used in the past: [_____]
- (g) Names and addresses of all entities which have been merged with the Company: [_____]
- (h) Names and addresses of all entities from whom the Company has acquired any movable asset through a transaction not in the ordinary course of that entity’s business along with the date of acquisition and the type of movable asset: [_____]

* Attached are copies of all organizational and related documents of the Company.

2. Location of the Company ¹

- (a) Current address of the place of central administration of the Company: [_____]

¹The locations of the grantor and its assets are particularly important for determining the law applicable in cross-border transactions (see part II.K).

(b) Addresses of other locations where the Company maintains or stores any inventory, equipment or other assets: [_____]

3. Assets of the Company

(a) Types of assets

Motor vehicles	Yes <input type="checkbox"/> No <input type="checkbox"/>
Equipment	Yes <input type="checkbox"/> No <input type="checkbox"/>
Inventory (raw material and finished goods)	Yes <input type="checkbox"/> No <input type="checkbox"/>
Receivables	Yes <input type="checkbox"/> No <input type="checkbox"/>
Registered copyrights, patents, trademarks and relevant applications	Yes <input type="checkbox"/> No <input type="checkbox"/>
Unregistered copyrights	Yes <input type="checkbox"/> No <input type="checkbox"/>
Licences to use trademarks, patents and copyrights	Yes <input type="checkbox"/> No <input type="checkbox"/>
Promissory notes and other negotiable instruments	Yes <input type="checkbox"/> No <input type="checkbox"/>
Equipment leased by the Company	Yes <input type="checkbox"/> No <input type="checkbox"/>

* Attached is a detailed schedule describing each asset and its location.

(b) Banks and other financial institutions at which the Company maintains a deposit account

Name of the bank	Address	Account information

4. Material contracts

[A list of material contracts to which the Company is a party, including: (i) loan and other financing agreements, inter-creditor agreements and guarantees with a schedule of all outstanding obligations; (ii) mortgages, pledges and security agreements; (iii) lease agreements relating to immovable property; and (iv) agreements regarding mergers and acquisitions, whether or not consummated.]

* Attached are copies of the material contracts to which the Company is a party.

5. Property of the Company subject to liens or encumbrances

Name of the holder of lien/encumbrance	Description of property

6. Potential or pending disputes²

[A list of pending disputes in which the Company is involved, including: (i) pending and potential arbitration, litigation, or claims against the Company for an indefinite amount or in excess of a certain amount for each case; (ii) administrative, governmental or regulatory investigations or proceedings; and (iii) claims other than claims on accounts receivable, which the Company is asserting or intends to assert, and in which the potential recovery exceeds a certain amount for each case.]

7. Affiliate transactions³

[A list of transactions between the Company and its affiliates, including management, tax-sharing and loan arrangements.]

* Attached are copies of any relevant agreements.

8. Tax assessments

(a) Tax assessments currently outstanding and unpaid by the Company

Tax authority	Description	Amount due

(b) Any pending audits or potential disputes with tax authorities: [_____]

* Attached are copies of the Company's tax filings for the past five years.

²An analysis of pending or potential claims can yield valuable information as to potential financial risks to which the company may be exposed, as well as how the company conducts its business. A lender may also wish to consult with the bankruptcy and insolvency officials to ensure that insolvency proceedings for each borrower and guarantor have not been commenced.

³It is important to verify that such transactions are conducted on an arms-length basis, rather than a potential source of self-dealing by the company.

9. Employee benefits

[A list of benefits provided by the Company to its employees.]

* Attached are copies of the employee pension benefit plan, revenue or profit-sharing plan, multi-employer plan or another pension plan.

10. Insurance policies of the Company

Insurer and policy number	Description of insurance policy	Type of coverage and limitations

11. Directors, managers and other officers of the Company

Name	Title	Telephone	Email

12. Miscellaneous

Indebtedness	<i>[A list of any current indebtedness of the Company that is to be paid off at the closing of the loan, including each creditor's name, a contact person and contact details, and the approximate amount of such indebtedness]</i>
Necessary consents	<i>[A list of any consents or approvals required in connection with the closing of the loans]</i>
Regulatory and licensing matters	<i>[A list of any regulatory/licensing compliance required of the Company due to the specific nature of its business and any notifications received by the Company for non-compliance with applicable law or regulation]</i>

13. Legal counsel representing the Company

Name of attorney	Affiliation	Telephone	Email

The Company agrees to inform you of any change or modification to any of the information above or any supplemental information provided in the attachments. Until such notice is received by you, you shall be entitled to rely on the information contained herein and in any of the attachments, and presume that it is all true, correct and complete.

[Date]

[Name of the grantor, including contact details]

[Signature of the grantor]

IV. Sample security agreements

As with all sample forms and templates in the annexes, the sample security agreements below should be read bearing in mind that other laws of the enacting State might have an impact on the transaction, possibly limiting the effectiveness of some of the terms in the security agreement.

A. Sample security agreement creating a security right in a specific asset

[*Name and address of the grantor (any other description of the grantor, including its place of central administration, the type of entity, and the law under which it was constituted)*] grants a security right in [*description of the encumbered asset (including, for example, location, manufacturer or serial number of the asset)*] in favour of [*name and address of the secured creditor*] to secure its obligation to pay [*amount*] under [*description of the agreement which gave rise to the obligation, including the date the agreement was entered into*].

[*Date*]

[*Name of the grantor*]

[*Name of the secured creditor*]

[*Signature of the grantor*]

[*Signature of the secured creditor*]

B. Sample security agreement covering all assets of the grantor

Security Agreement

between

[*Name and address of the grantor*] (the “Grantor”)

and

[*Name and address of the secured creditor*] (the “Secured Creditor”)

Preamble

The Secured Creditor has agreed to make available to the Grantor a line of credit to finance the operations of the Grantor pursuant to a credit agreement¹ on [*date of the credit agreement*] (as same may be amended, supplemented or restated from time to time, the “Credit Agreement”).

The execution of this agreement is a condition for the extension of credit by the Secured Creditor to the Grantor under the Credit Agreement.

¹The term “credit agreement” is used as a generic term to describe the agreement under which credit is to be extended by the creditor. Other terms may be used depending on the nature of the transaction or local practices.

1. Definitions

In this agreement:

- (a) Each term which is defined in [*the law of the State enacting the Model Law*] has the meaning given to it by that Law;
- (b) “Event of Default” means (i) any event that constitutes an “event of default” under the Credit Agreement, and (ii) any failure by the Grantor to comply with any of its obligations under this agreement.

2. Creation of the security right and the secured obligations

2.1 Creation of the security right

The Grantor creates in favour of the Secured Creditor a security right in all of the Grantor’s present and future assets (the “Encumbered Assets”), which are within the following categories:²

- (a) Inventory;
- (b) Receivables;
- (c) Equipment;
- (d) Funds credited to a bank account;
- (e) Negotiable documents, including without limitation, bills of lading and warehouse receipts;
- (f) Negotiable instruments, including without limitation, bills of exchange, cheques and promissory notes;
- (g) Intellectual property and rights as licensee of intellectual property; and
- (h) To the extent not listed above, all proceeds³ and products of all of the foregoing.

2.2 Secured Obligations

The security right secures all present and future obligations of the Grantor to the Secured Creditor under or contemplated by the Credit Agreement and this agreement (“Obligations”).

²When all present and future assets of the Grantor are intended to be encumbered, the list would not be necessary. It would be enough simply to refer to “all present and future assets.” The list is provided as an example when the parties wish to limit the security right to certain categories of assets.

³While a security right in encumbered assets extends to its identifiable proceeds, the parties may wish to include in the description of the original encumbered assets, in both the security agreement and the notice in the Registry, all types of asset that are likely to become proceeds. This would eliminate the possible need to amend the registration to include a description of the proceeds (see section II.A.7 and example 13).

3. Representations of the Grantor

3.1 Location of certain Encumbered Assets

- (a) The inventory and the equipment of the Grantor are and will be held or used by the Grantor at all times in [State to be specified] and, unless the Grantor notifies the Secured Creditor of a change, at the addresses listed in the annex to this agreement;⁴
- (b) The addresses of the debtors of the receivables owed or to be owed to the Grantor are and will at all times be in [State to be specified], unless the Grantor notifies the Secured Creditor of a change specifying other State(s) in which debtors of these receivable have addresses;⁵ and
- (c) The bank accounts of the Grantor are and will be held at all times at branches of banks in [State to be specified], and, unless the Grantor notifies the Secured Creditor of a change, at the addresses listed in the annex to this agreement. The account agreements relating to these bank accounts are and will be governed by the relevant law of the State in which the applicable branch is located and do not and will not refer to another law for matters relevant to this agreement.⁶

3.2 Location and name of the Grantor⁷

- (a) The registered office and the place of central administration of the Grantor are and will be located at all times in [State to be specified]; and
- (b) The Grantor's exact name and the State of its constitution are as specified in this agreement. The Grantor will not change its State of constitution without the prior written consent of the Secured Creditor and will not change its name without giving to Secured Creditor a thirty (30) day prior notice of the change.

⁴This will enable the secured creditor to identify the law applicable to the creation, effectiveness against third parties and priority of its security right in the inventory and equipment (ML art. 85), which will enable the secured creditor to determine where registration needs to be made.

⁵This will enable the secured creditor to identify the law applicable to its rights and obligations in relation to the debtors of the receivables (ML art. 96).

⁶This will enable the secured creditor to identify the law applicable to rights to payment of funds credited to a bank account (ML art. 97).

⁷This will enable the secured creditor to identify the law applicable to the creation, effectiveness and priority of its security right in the grantor's receivables (ML art. 86).

4. Authorizations relating to the Encumbered Assets

4.1 Registration of notices

The Grantor authorizes the Secured Creditor to register any notice and to take any other action necessary or useful to make the Secured Creditor's security right effective against third parties.

4.2 Inspection and copies

- (a) The Secured Creditor may inspect the Encumbered Assets and the documents or records evidencing same and, for such purposes, may enter the Grantor's premises, upon giving prior reasonable notice to the Grantor; and
- (b) At the request of the Secured Creditor, the Grantor will furnish to the Secured Creditor copies of the invoices, contracts and other documents evidencing its receivables.

4.3 Dealings with Encumbered Assets

- (a) Until the Secured Creditor notifies the Grantor that an Event of Default has occurred, the Grantor may sell, lease, license or otherwise dispose of its inventory and documents of title, collect its receivables and negotiable instruments and dispose of worn-out or obsolete equipment, in each case, in the ordinary course of its business;
- (b) The Grantor will not grant any security right in the Encumbered Assets and, except as permitted by paragraph (a), will not sell, lease, license or otherwise dispose of the Encumbered Assets;⁸ and
- (c) Unless otherwise agreed between the parties, the Secured Creditor may at any time notify the debtors of the Grantor's receivables of the existence of its security right. However, a notification given prior to the occurrence of an Event of Default will authorize the debtors to make their payments to the Grantor until otherwise instructed by the Secured Creditor following the occurrence of an Event of Default.⁹

5. Undertakings relating to the Encumbered Assets

5.1 Movable assets

The Grantor undertakes that the Encumbered Assets will remain movable assets at all times and will not be physically attached to immovable property.

⁸This prohibition is a contractual obligation and is not binding upon third parties. For example, a third party who purchases an encumbered asset may acquire it free of the security right in certain circumstances (see section II.G.2).

⁹While a notification to the debtor of a receivable may be given at any time, the parties will often include such authorization in the security agreement (ML art. 63(2)).

5.2 Effectiveness of the security right

The Grantor will take all actions and execute all documents reasonably required by the Secured Creditor for its security right to be at all times enforceable and effective and enjoy priority against third parties in all jurisdictions where the Encumbered Assets may be located or where the security right may be enforced.

5.3 Bank accounts

The Grantor will take all steps required for the Secured Creditor's security right to be made effective against third parties through a control agreement with respect to all funds credited to a bank account held with a bank.¹⁰

6. Enforcement

6.1 Rights after an Event of Default

After the occurrence of an Event of Default and while it is continuing:

- (a) The Secured Creditor may enforce its security right and exercise all rights of a secured creditor under the [*the law of the State enacting the Model Law*] and any other applicable law;
- (b) Subject to any mandatory provision of applicable law, the Secured Creditor may also:
 - (i) collect the Grantor's receivables and negotiable instruments, compromise or transact with the debtors of these receivables and instruments, and grant discharges to them; and
 - (ii) take all other actions necessary or useful for the purpose of realizing the value of the Encumbered Assets, including without limitation completing the manufacture of inventory and purchasing raw materials.

6.2 Access to the Grantor's premises

The Grantor permits the Secured Creditor to enter into and use the premises where the Encumbered Assets are located for the purposes of the Secured Creditor exercising its enforcement rights.

6.3 Manner of enforcement

The enforcement rights may be exercised on all of the Encumbered Assets taken as a whole or separately in respect of any part of them.

¹⁰The Model Law recognizes control agreements as a method of achieving third-party effectiveness (see ML art. 25, see example 8A). If the secured creditor is the deposit-taking institution, it will benefit from automatic third-party effectiveness (see example 8B).

6.4 Reimbursement of expenses

The Grantor will reimburse the Secured Creditor upon demand for all costs, fees and other expenses incurred by the Secured Creditor in the exercise of its rights with interest at annual rate of [percentage].

7. General Provisions

7.1 Additional and continuing security

The security right created by this agreement is in addition to, and not in substitution for, any other security right held by the Secured Creditor and is a continuing security that will subsist notwithstanding the payment from time to time, in whole or in part, of any of the Obligations. However, the security right will extinguish when the commitment to extend credit under the Credit Agreement has terminated and all Obligations have been satisfied in full.

7.2 Collections

Any sum collected by the Secured Creditor from the Encumbered Assets prior to all the Obligations becoming due may be held by the Secured Creditor as Encumbered Assets.

7.3 Other recourses

The exercise by the Secured Creditor of any right will not preclude the Secured Creditor from exercising any other right provided in this agreement or by law, and all the rights of the Secured Creditor are cumulative and not alternative. The Secured Creditor may enforce its security right without being required to exercise any recourse against any person liable for the payment of the Obligations or to realize on any other security.

7.4 Inconsistency with the Credit Agreement

In the event of any conflict or inconsistency between the provisions of this agreement and the provisions of the Credit Agreement, the provisions of the Credit Agreement will prevail.

8. Governing Law

This agreement will be governed by and construed in accordance with the laws of [State to be specified]. The provisions of this agreement should be interpreted in a way that gives effect to the intent of the parties that the Secured Creditor's security right be valid and effective in all jurisdictions where the Encumbered Assets may be located and where the rights of the Secured Creditor may have to be enforced.

9. Notices

Any notice by a party to the other party must be in writing and given in accordance with the notice provisions of the Credit Agreement.

[Date]

[Name of the grantor]

[Name of the secured creditor]

[Signature of the grantor]

[Signature of the secured creditor]

V. Sample retention-of-title clause

The following provides a sample retention-of-title clause for use in a sales contract relating to a specific asset which is intended to be used by the purchaser in the operation of its business (see section II.D.3). It will need to be modified if the sales contract relates to assets which will be held by the grantor as inventory for resale or manufacturing. The inclusion of a retention-of-title clause creates a security right in the asset under the Model Law and the seller will need to comply with other requirements of the Model Law to protect its security right (see section II.A.6 and example 6A).

The Asset sold under this contract will remain the property of the Seller until the purchase price has been paid in full to the Seller. The ownership of the Asset will be transferred to the Buyer only when the full payment has been made.

The Buyer authorizes the Seller to register any notice and take any other action necessary to make the Seller's retention of ownership in the Asset effective against third parties.

Until ownership of the Asset has been transferred to the Buyer, the Buyer will not sell, lease or otherwise dispose of the Asset or grant a security right in the Asset, in each case, without the written consent of the Seller.

The Buyer will not attach or affix the Asset to immovable property without the prior written consent of the Seller.

VI. Sample template: A grantor's authorization for registering a notice in the Registry before a security agreement is entered into

The undersigned (the "Grantor") authorizes [*the name and address of the secured creditor*] and any of its representatives to register a notice in [*the name of the Registry in the enacting State*] with respect to the security right in [complete only one]:

- all of the Grantor's present and future movable assets
- all of the Grantor's present and future movable assets except the following items or types of assets: [*description of items or types of assets*]
- the following items/types of assets: [*description of items or types of assets*]

The maximum amount, for which any security right that is granted in the assets described above may be enforced, is the following¹: [*amount*]

[*Date*]

[*Name of the grantor*]

[*Signature of the grantor*]

¹This text is only relevant if the enacting State requires the maximum amount for which the security right may be enforced to be included in the security agreement and in the notice (ML art. 6(3)(d) and MRP art. 8(e)).

VII. Sample template: A grantor's request for the registration of an amendment or cancellation notice

When obliged to do so, a secured creditor will in most cases voluntarily register an amendment or cancellation notice (see table in section II.E.10). If it does not, the grantor can send a written request to the secured creditor asking it to do so. The following provides a template for the grantor to use when making such a request to the secured creditor.

To [*name of the secured creditor*],

A notice was registered on [*date of registration*] in the [*the name of the Registry in the enacting State*] with the registration number [*to be inserted*] (the "Notice"). In the Notice, you are named as the secured creditor and I am named as the grantor.

[*Explanation of the circumstance which requires the registration of an amendment or cancellation notice*]

Therefore, I request that the Notice [*complete only one*]:

- be cancelled by registering a cancellation notice
- be amended by registering an amendment notice that deletes the following assets from the description of encumbered assets: [*list of assets*]
- be amended by registering an amendment notice that reduces the maximum amount for which the security right may be enforced to the following¹: [*amount*].

According to [*relevant provision, for example, article 20(6) of the Model Registry Provisions*], you are required to register the above-mentioned notice no later than [*number of days specified by the enacting State*] days after you receive this request. If you fail to register the requested notice, I am entitled to seek an order for its registration.

[*Date*]

[*Name of the grantor*]

[*Signature of the grantor*]

¹This text is only relevant if the enacting State requires the maximum amount for which the security right may be enforced to be included in the security agreement and in the notice (ML 6(3)(d) and MRP arts.8(e) and 20(2)).

VIII. Sample template: A borrowing base certificate

Name of Borrower			
Name of Lender			
Loan Number			
Certificate Number			
Period Covered	[DD/MM/YYYY] to [DD/MM/YYYY]		
Description	Category of assets		Total Eligible Collateral
	Inventory	Receivables	
1. Beginning Balance (if applicable from previous certificate)			
2. Additions to Collateral (Gross Sales / Purchases)			
3. Deductions to Collateral (Cash Received)			
4. Other Deductions to Collateral ¹			
5. Total Collateral Balance			
6. Ineligible Receivables ²			
7. Ineligible Inventory ³			
8. Total Eligible Collateral (Line 5 minus Lines 6 & 7)			
9. Advance Rate Percentage (per loan agreement)	%	%	
10. Net Available to Borrower (Borrowing Base Value) (Line 8 multiplied by Line 9)			
11. Reserves ⁴			
12. Total Borrowing Base Value (Line 10 minus Line 11)			
13. Maximum Revolving Line of Credit			Total Credit Line
14. Maximum Borrowing Limit (Lesser of 12 and 13)			Total Available
Pursuant to [<i>description of the loan agreement</i>], the undersigned represents and warrants to the Lender that the information contained in this Borrowing Base Certificate is true and correct.			
[Date] [Name of the borrower] [Signature of the borrower]			

Please see over for notes.

¹Include those resulting from discounts or credits given to customers.

²Include receivables that are ineligible or unacceptable for borrowing. For example, receivables that are:

- past due beyond a specified number of days;
- deemed to be past due because a sufficiently high percentage of the receivables owed by the same debtor are past due;
- owed by foreign customers; or
- subject to set-off by the customer.

³Include inventory that is ineligible or unacceptable for borrowing. For example, inventory that:

- is obsolete or slow-moving;
- is not physically located on the grantor's premises either because it is held by a third party (such as a processor or a storage warehouse) or is in-transit to the grantor's place of business and is not covered by an acceptable agreement giving the secured creditor access to, and control of, the inventory;
- consists of work-in-process that is not readily saleable; or
- is not owned by the grantor, but rather has been delivered to the grantor's premises by a third party on consignment.

⁴Include reserves, for example, for priority claims for unpaid wages or taxes by operation of other laws in the enacting State.

IX. Sample template: A secured creditor's notice of intention to sell the encumbered asset

As a way of enforcing its security right, a secured creditor can sell the encumbered asset itself (ML art. 78, see section II.I.4). The following is a sample template of the notice which can be used by a secured creditor when notifying the grantor that it intends to sell the encumbered asset. The template can also be adapted by a secured creditor when it sends the notice to other persons as required by article 78(4) of the Model Law.

To [*name of the grantor*],

According to [*description of the security agreement*], the undersigned has a security right in the [*description of the encumbered asset*] (the "Collateral") to secure payment arising from [*description of the transaction which gave rise to the secured obligation*]. At present, the payment of [*amount to satisfy the secured obligation including interest and enforcement cost*] is required to satisfy the secured obligation and to extinguish the security right.

The undersigned informs you of its intention to sell the Collateral to satisfy the secured obligation, which will take place on [*date on which the encumbered asset will be sold*].

You or any other person with a right in the Collateral may terminate this sale by paying the above-mentioned amount to the following:

- [*Name of the secured creditor and contact details*]
- [*Account information for making wire transfer or direct payment*]

If payment is not made before the above-mentioned date, the undersigned will proceed with the sale.

[*Date*]

[*Name of the secured creditor*]

[*Signature of the secured creditor*]

X. Sample template: A secured creditor's proposal to acquire the encumbered asset

As a way of enforcing its security right, a secured creditor can propose to acquire the encumbered asset either in total or partial satisfaction of the secured obligation (ML art. 80, see section II.I.4). The following is a sample template which can be used by a secured creditor when proposing to the grantor to acquire the encumbered asset in full satisfaction of what it is owed. The template can also be adapted by a secured creditor when it sends the proposal to other persons as required by article 80(2) of the Model Law.

To [*name of the grantor*],

According to [*description of the security agreement*], the undersigned has a security right in the [*description of the encumbered asset*] (the "Collateral") to secure payment arising from [*description of the transaction which gave rise to the secured obligation*]. At present, the payment of [*an amount to satisfy the secured obligation including interest and enforcement cost*] is required to satisfy the secured obligation and to extinguish the security right.

According to [*relevant provision, for example, article 80 of the Model Law*], the undersigned offers to acquire the Collateral in full satisfaction of the secured obligation.

You or any other person with a right in the Collateral may terminate this acquisition by paying the above-mentioned amount to the following:

- [*Name of the secured creditor and contact details*]
- [*Account information for making wire transfer or direct payment*]

You or any other person with a right in the Collateral may raise an objection to the proposed acquisition in writing. If no objection is received before [*a date taking into account the period of time specified by the enacting State for the recipients of the proposal to raise an objection*], the undersigned will acquire the Collateral on that date.

[*Date*]

[*Name of the secured creditor*]

[*Signature of the secured creditor*]

XI. Sample template: A secured creditor's payment instructions to the debtor of a receivable

The following is a sample template which can be used by a secured creditor when enforcing its security right in a receivable. It requests the debtor of the receivable to make payment to the secured creditor (ML art. 82, see section II.I.4). The template can also be adapted by a secured creditor with a security right in a negotiable instrument or a bank account to request the obligor under the negotiable instrument or the deposit-taking institution to make payment to it. The language in the payment instruction should follow the wording of the contract that gave rise to the obligation.

To [*name of the debtor of the receivable*],

According to [*description of the security agreement*], the undersigned has a security right in [*description of the receivable*] in favour of [*name of the grantor*] arising from [*description of the transaction which gave rise to the receivable*]. This includes all receivables which will arise in the future where the debtor of the receivable is obliged to pay [*name of the grantor*].

According to [*relevant provision, for example, article 82 of the Model Law*], the undersigned has the right to collect payment of the receivable owed by you and to enforce any personal or property right that secures or supports payment of the receivable.

You are instructed to make all payments which are currently due or will become due to the following:

- [*Name of the secured creditor and contact details*]
- [*Account information for making wire transfer or direct payment*]

[*Date*]

[*Name of the secured creditor*]

[*Signature of the secured creditor*]

Further information may be obtained from:

UNCITRAL secretariat, Vienna International Centre
P.O. Box 500, 1400 Vienna, Austria

Telephone: (+43-1) 26060-4060
Internet: uncitral.un.org

Telefax: (+43-1) 26060-5813
E-mail: uncitral@un.org

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