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Draft Security Rights Registry Guide

Note by the Secretariat

Addendum

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IV. Rules applicable to the registration and search process

A. Introduction

1. In the interest of legal certainty, a State establishing a security rights registry will need to implement a set of rules to regulate the registration and search process. The goal of this chapter is to identify the issues that must be addressed in these rules and provide guidelines for their treatment in line with the recommendations of the *Guide* (in particular, chapter IV).

B. Grantor authorization for registration

2. As already noted (see A/CN.9/WG.VI/WP.46, para. 25), under the law recommended in the *Guide*, registration of a notice in the general security rights registry is one of the methods for making the security right effective against third parties and priority among security rights made effective against third parties by such a registration is determined on the basis of the time of registration (see recommendations 32 and 76). As registration or failure to effect a registration has consequences for the third-party effectiveness and priority of a security right the secured creditor is entitled to effect a registration with respect to its security right, either directly or through a representative such as a law firm or other service provider, provided that the necessary arrangements for access to the registry services have been made with the registry (see A/CN.9/WG.VI/WP.46/Add.2, paras. 49-52).

3. Under the approach recommended in the *Guide*, the registration of a notice with respect to a security right must be authorized by the grantor before or after registration. This requirement may be satisfied not only by a specific authorization given to the secured creditor by the grantor but also by an off-record written security agreement (see recommendation 71).

4. In contrast, some registry systems require the grantor's consent to be evidenced on the registry record itself. This requirement adds cost and time to the registration process since, to be useful, it would require reliable verification by the registry staff of the fact that the person giving consent is in fact the grantor named in the registration. Such a requirement would also add complexity to the implementation of a registry system permitting the direct entry of information into the registry record via electronic media as an alternative to the submission of a paper form (see A/CN.9/WG.VI/WP.46/Add.2, paras. 44-46).

5. Legal systems that require the grantor's authorization to appear on the registry record may be influenced by an inappropriate analogy with title registries. In a title registry, such a requirement makes sense insofar as the rights of the true owner may be lost if an unauthorized transfer is entered on the record and the person named as the new owner then proceeds to dispose of the asset. However, in a security rights registry of the kind recommended in the *Guide*, registration does not create a security right or evidence that it actually exists; it merely provides notice of the possible existence of a security right in the described assets (see recommendations 32 and 33). This is prejudicial to the person identified in the

registration as the grantor only insofar as it may impede that person's ability to deal freely with the assets described in the registration until the registration is cancelled.

6. As already noted (see A/CN.9/WG.VI/WP.46, para. 68), the risk of unauthorized registrations can more efficiently be dealt with by enabling the person identified in an unauthorized registration as the grantor to quickly and inexpensively compel the cancellation or amendment of the unauthorized registration through a summary administrative or judicial procedure. This is the approach recommended in the *Guide* (see recommendations 54, subpara. (d), and 72, and A/CN.9/WG.VI/WP.46/Add.2, para. 20). To facilitate the exercise of this right of the grantor, a registrant is required to send a copy of the initial or any subsequent amendment notice to the grantor (see recommendation 55, subpara. (c)); in an electronic system, the registry may be designed so as to send this copy automatically (see A/CN.9/WG.VI/WP.46/Add.2, paras. 36-38).

7. Further protection against unauthorized registrations can be achieved by requiring potential registrants to provide some form of identification as a pre-condition to submitting a registration (see recommendation 55, subpara. (b)). In this way, the system has a record of the identity of the registrant (see paras. 34-36 below). Requiring registrants to identify themselves does not undermine the efficiency of the registration process as long as the registrar does not need to verify the identity of the registrant (see recommendation 54, subpara. (d)). Unlike the grantor, registrants are likely to be repeat customers. Consequently, a registrant will only need to produce identification on its initial application for access to the registry; once it has been granted access enabling it to submit information in notices, subsequent registrations can be entered without the registrant continuously having to provide evidence of identity.

8. An additional way to minimize unauthorized registrations is to subject a person that effects an unauthorized registration to liability for any damages caused to the person identified in the registration as the grantor and to criminal or monetary penalties if it is established that the registrant made the registration in bad faith or intent to harm the interests of the grantor.

C. Advance registration

9. As already explained (see A/CN.9/WG.VI/WP.46, paras. 65-69), in the notice registration system recommended in the *Guide*, the registrant does not register the actual security documentation. All that is registered is the basic information contained in the notice in line with the law and needed to alert a third-party searcher that a security right may exist in the described assets. This approach enables registrants to register even before the conclusion of a security agreement between the grantor and the creditor or before the creation of the security right to which the registration refers. The *Guide* recommends that advance registration be expressly permitted by law (see recommendation 67). Thus, advance registration that has been properly authorized by the grantor may not be later challenged as being ineffective because it took place before the security agreement was entered into or the security right created. Advance registration also enables a potential secured creditor (with proper authorization from the grantor) to establish its priority position against secured creditors that register or otherwise make their security rights effective

against third parties at a later stage. This in turn eliminates the delay in extending credit to the grantor that would otherwise result if registration could be made only after the security agreement has been entered into. Registration by itself does not, however, ensure that the secured creditor will necessarily have priority over other classes of competing claimants. As explained in chapter II (see A/CN.9/WG.VI/WP.46, para. 53), registration does not create or evidence the creation of a security right. Consequently, until the security agreement is actually entered into and the other requirements for creation of an effective security right are satisfied, the secured creditor may be defeated by a competing claimant, such as a buyer that acquires rights in the encumbered assets in the intervening period between advance registration and the creation of the security right.

10. If the negotiations are aborted after the registration is effected and no security agreement is ever entered into between the parties, the creditworthiness of the person named as grantor in the registration may be adversely affected unless the registration is cancelled. This risk, like the risk of unauthorized registrations generally, can be controlled by: (a) requiring the secured creditor (or, in the case of an electronic registry, the registry system) to notify the grantor in a timely manner about the registration (see recommendation 55, subpara. (c)); (b) making it an obligation for the secured creditor to cancel a registration in certain cases (see recommendation 72, subpara. (a)); and (c) providing a summary procedure to enable the person identified in the registration as the grantor to compel the cancellation of the registration (see recommendations 54, subpara. (d), and 72, subparas. (b) and (c), as well as A/CN.9/WG.VI/WP.46/Add.2, paras. 15-20).

D. One registration for multiple security agreements

11. In a notice registration system (in which the information in the security documentation is not entered into the registry record), there is no reason why a single registration should not be sufficient to give third-party effectiveness to, present or future, security rights arising under multiple security agreements between the same parties. Requiring a one-to-one relationship between each registration and each security agreement would generate unnecessary costs and undermine the ability of the secured creditor to flexibly respond to the grantor's evolving financing needs without having to fear a loss of the priority position it holds under the initial registration.

12. Consequently, the *Guide* recommends that the law should expressly provide that a single registration is sufficient to achieve third-party effectiveness with respect to security rights, whether they exist at the time of registration or are created later and whether they arise from one or more security agreements between the same parties (see recommendation 68). The registration continues to be effective, however, only to the extent that the registered information reflects the terms of any new or amended security agreement. For example, if a new security agreement covers new assets that were not described in the prior registration, a new registration would be needed. Otherwise third parties searching the registry would be misled into thinking that the additional assets were unencumbered.

E. Minimum registration information

1. Grantor information

(a) General

13. As already explained (see A/CN.9/WP.46, paras. 70-72), information contained in notices is indexed by reference to the grantor's identifier and not to the encumbered asset. In order to ensure that a search of the registry discloses all security rights that may have been granted by a person, the rules applicable to registration should make it clear that this information is an essential component of an effective registration.

14. While the grantor's address is not part of the grantor identified, it should also be required to: (a) assist in grantor identification, if necessary (for example, where the grantor's name is common); (b) enable the registrant (or, in the case of an electronic registry, the registry system) to forward copies of registered notices to the grantor; and (c) enable searchers that are not already dealing with the grantor to contact the grantor for further information. This is the approach recommended in the *Guide* (see recommendation 57, subpara. (a)).

15. Some States provide for exceptions to the requirement to include the grantor's address where personal security concerns necessitate that an individual grantor's address details not be disclosed in a publicly accessible record (although using a post office box or similar non-residential mailing address may alleviate this concern). In those States, interested parties are required to contact the secured creditor and obtain further information about the grantor, if they are not already in contact with the grantor.

16. It should be noted that, the grantor's address plays less of a role in systems in which the required grantor identifier is unique (for example, a government-issued identification number) as compared to systems in which the identifier is the grantor's name and in which a search may disclose multiple security rights granted by different grantors that share the same name (see paras. 24-26 below).

17. It is not uncommon for a person to create a security right in its assets to secure an obligation owed by a third-party debtor. Since the object of registration is to disclose the possible existence of a security right in the assets described in the registration, the rules applicable to the registration process should make it clear that the person whose identifier and address must be included in the registration is the person that owns, or has rights in, the encumbered assets, and not the debtor of the secured obligation (or a mere guarantor of the obligation owed by the debtor).

18. To provide legal certainty for registrants and third-party searchers, the applicable rules should also provide explicit guidance on what constitutes the correct grantor identifier. Otherwise, a secured creditor (that is responsible for entering the correct grantor identifier) cannot be confident that its registration will be legally effective and searchers cannot confidently rely on a search result. This is the approach recommended in the *Guide* (see recommendation 58). The next sections of the text address this issue.

(b) Natural persons versus legal persons

19. The general security rights registry contemplated by the *Guide* envisages that grantor information normally will be stored in a centralized and consolidated registry record (see A/CN.9/WG.VI/WP.46/Add.2, paras. 47 and 48) but that the registry system will distinguish and allow searchers to retrieve registrations depending on whether the grantor is a natural or legal person (see recommendations 59-60). This design feature recognizes that different identifier rules will be required for the two categories of grantor owing to differences in the naming conventions for each category.

20. This design feature has implications for the registration and searching process. It is critical that registry searchers understand that the registry system distinguishes between the identifier information for grantors that are natural persons and the identifier information for grantors that are legal persons. Accordingly, a search of the registry record against the identifier of a natural person will not disclose a security right registered against a grantor that is a legal person, and the converse is also true. In any case, registrants must ensure that the grantor information is entered in the field or screen designated for the category of grantor with whom they are dealing.

(c) Grantor identifier criteria for natural persons

21. The *Guide* recommends that, if the grantor is a natural person, the identifier of the grantor for the purposes of an effective registration is the name of the grantor as it appears in a specified official document (see recommendation 59).

22. A rule implementing this approach may specify, as the following table illustrates, examples in order to accommodate the particular circumstances of different grantors (the responsibility for entering the correct identifier of the grantor in accordance with these rules lies with the registrant):

Grantor status	**Required identifier**
Born in enacting State	(1) Personal identification number (2) Name on birth certificate or equivalent official document
Born in enacting State but birth not registered in enacting State	(1) Name on current passport (2) If no passport, name on other official document (e.g. driver's licence) (3) If no passport or card, name on current foreign passport from jurisdiction of habitual residence
Born in enacting State but birth name subsequently changed pursuant to change of name legislation	Name on a certificate or equivalent document (such as a marriage certificate)
Not born in enacting Sate but naturalized citizen of enacting State	Name on citizenship certificate

Not born in enacting State and not a citizen of enacting State	(1) Name on current passport issued by the State of which the grantor is a citizen (2) If no current foreign passport, name on birth certificate or other official document issued at grantor's birth place
None of the above	Name on any two official documents issued by the enacting State, if those names are the same (for example, a current motor vehicle operator's licence and a current government medical insurance identification card)

23. It is equally important to have clear rules specifying what components of the name as stated in the specified official document are required (for example, family name, followed by the first given name, followed by the second given name) and also to provide guidance for exceptional situations (for example, where the grantor's name consists of a single word). The name parts should be treated as individual parts and thus each name part should have its own field or screen and not concatenated into one single element.

24. In many States, many persons have common names, with the result that a search may disclose multiple grantors with the same family name and given names. The law recommended in the *Guide* provides that, in such cases, additional information, such as the birth date or an identity card number, may be used to identify the grantor. Whether the use of a government-issued personal identification number (alphanumeric or other code) is feasible and desirable depends on three principal considerations. First, whether the public policy of the enacting State permits the public disclosure of the identification numbers assigned to its citizens and residents. Second, if so, whether the system under which the numbers are issued is sufficiently universal and reliable to ensure that each natural person is assigned a unique number. Third, whether there is a documentary or other source by which third-party searchers can objectively verify whether a particular number relates to the particular grantor in whose assets searchers are interested. If searchers must instead rely solely on the grantor's representations as to the grantor's identification number, this may not be reliable. In addition, using national identification numbers might pose problems for the grantor's unsecured creditors or the insolvency representative since the grantor may not be prepared to voluntarily provide the number to them (in such a case, unsecured creditors or insolvency representatives of the grantor would have to obtain a court order to gain access to such number); similar problems may also arise with respect to verifying the documentary source of the grantor's correct name.

25. Even if a State-issued personal identification number is used to identify a grantor, it will still be necessary to include supplementary rules for determining the correct name of the grantor along the lines set forth above in order to accommodate cases where the grantor is not a citizen or resident of the State and therefore has not been issued a personal identification number (unless a State accepts the number of the foreign passport as sufficient to identify foreign nationals).

26. Additional information to identify the grantor may also include the grantor's address but only if this information is known by the searcher. It should be noted

though that, under the law recommended in the *Guide*, the grantor's address is part of the information that has to be included in a notice but not necessarily of the grantor identifier (see recommendations 57, subpara (a), and 59). In any case, there is a need for restraint in demanding supplementary information, since the more detail that is required to be included the greater the risk of registrant error and privacy concerns.

(d) Grantor identifier criteria for legal persons

27. To determine the correct identifier for grantors that are legal persons, the *Guide* recommends that the correct name for the purposes of an effective registration is the grantor's name as it appears in the document constituting the legal person (see recommendation 60). Virtually all States maintain a public commercial or corporate register for recording information about legal persons constituted under the law of that State including their names. Accordingly, the required identifier for registration and searching purposes should be the name as it appears on the public record. In many States, upon registration in that record, a unique and reliable registration number is assigned to each entity and used as the grantor identifier.

(e) Other types of grantor

28. The rules governing registration will also need to set out additional guidelines on the required grantor identifier in transactions where the grantor does not precisely fit into either the natural person or the legal person categories. The following table illustrates the types of situations that will need to be addressed, together with examples of required identifiers:

Grantor status	**Required identifier**
Estate of a deceased natural person	Identifier of the deceased person, determined in accordance with the rules for grantors who are natural persons, with the specification in a separate field that the grantor is an estate
Insolvency representative acting for an insolvent natural person	Identifier of the insolvent natural person, determined in accordance with the rules for grantors who are natural persons, with the specification in a separate field that the grantor is insolvent
Insolvency representative acting for an insolvent legal person	Identifier of the insolvent legal person determined in accordance with the rules for grantors who are legal persons, with the specification in a separate field that the grantor is "insolvent"
Trade union that is not a legal person	Name of the trade union as set out in its constitutive document and the identifier information for each person representing the trade union in the transaction giving rise to the registration determined in accordance with the rules for grantors who are natural persons

Trust where the document creating the trust designates the name of the trust	Name of the trust as set out in the document constituting the trust, with the specification in a separate field that the grantor is a "trust" unless the name of the trust already contains the word "trust", and the identifier information of the trustee determined in accordance with the rules for natural persons or legal persons as the case may be
Trust where the document creating the trust does not designate the name of the trust	Identifier information of the trustee, determined in accordance with the rules for grantors who are natural persons or legal persons as the case may be, with the specification in a separate field that the grantor is a "trustee"
Participant in a legal person that is a syndicate or joint venture	Name of the syndicate or joint venture as stated in the document creating it, and the identifier information for each participant determined in accordance with the rules for grantors who are natural persons or legal persons as the case may be
Participant in a legal person other than a syndicate or joint venture	Name of the legal person as stated in the document creating it, and the identifier information of each natural person representing the legal person in the transaction to which the registration relates, determined in accordance with the rules for grantors who are natural persons
Any other organization that is not a natural or legal person not already referred to above	Name of the organization as stated in the documents of the organization, and the identifier information for each natural person representing the organization in the transaction to which the registration relates, determined in accordance with the rules for grantors who are natural persons

29. In the case of sole proprietorships, even though the business may be operated under a different business name and style than that of the proprietor, registry rules typically require entry of the grantor's identifier in accordance with the rules applicable to grantors who are natural persons. Systems for electronic entry of information and registration forms may be designed to allow registrants to select a box with the appropriate designation instead of entering the designation in the name field of the grantor.

(f) Grantor information and impact of error

30. As the grantor's identifier is the search criterion for retrieving information submitted in a notice and entered in the registry record, the law recommended in the *Guide* provides guidance on whether an error in the identifier submitted by the registrant would render a registration ineffective, with the result that third-party effectiveness of the security right would not be achieved. The relevant rule makes it clear that the test should not be based on whether the error appears to be minor or trivial in the abstract, but whether it would cause the information in the registry record not to be retrieved by a search of the registry record under the correct grantor

identifier (see recommendation 58). The test is an objective one; that is to say, the registration is ineffective if this test is not satisfied regardless of whether person challenging the effectiveness of the registration suffered any actual prejudice as a result of the error.

31. The law recommended in the *Guide* does not prescribe the impact of an error in grantor information that does not constitute a search criterion, for example, an error in the address of the grantor or in the grantor's birth date where this latter information is required to be entered. Guidance on this issue should be included in the regulations applicable to registration and searching. By analogy to the general test recommended by the *Guide* for errors in the entry of secured creditor information, the regulations should specify that an error in the grantor information that does not constitute a search criterion renders the registration ineffective only if it would seriously mislead a reasonable searcher (see recommendation 64). A scenario where this test might be satisfied is where the search results disclose numerous grantors all bearing the same name and the error in the entry of the supplementary information is so acute as to make it infeasible for a reasonable searcher to determine whether the relevant grantor is or is not included in the list.

32. In some registry systems that rely on electronic records, software is used that returns close matches to the correct grantor identifier (where the identifier is a name). Such systems may allow a registration to be considered effective even though the registrant has made a minor error in entering the grantor identifier. The reason for this approach is that a searcher entering the correct grantor identifier would retrieve the registration and consider it likely that the grantor whose identifier appears on the search result as an inexact match is nonetheless the relevant grantor. Whether this is the case depends on such factors as whether: (a) a reasonable searcher would be able to readily identify the correct grantor by referring to other information, such as address; (b) the list of inexact matches is so lengthy as to prevent the searcher from efficiently determining whether the grantor in which it is interested is included in the list; and (c) the rules for determining "close" matches are objective and transparent so that a searcher will be able to rely on the search result.

33. In some registry systems, the indexing and search logic in relation to the electronic record of grantors that are legal persons is programmed to ignore all punctuation, special characters and case differences and to ignore selected words or abbreviations that do not make an identifier unique (such as articles of speech and indicia of the type of enterprise such as "company", "partnership" "LLC" and "SA"). Where this is the case, an error in the entry of this type of information will not render the registration ineffective since the registration will still be retrieved despite the error.

2. Secured creditor information and impact of error

34. The rules applicable to the registration process invariably require that the identifier of the secured creditor or the secured creditor's representative, along with its address, be included in the notice submitted to the registry. This is the approach recommended in the *Guide* (see recommendation 57, subpara. (a))

35. The identifier rules that apply to the grantor should apply also to the secured creditor at least where the grantor's identifier is the grantor's name, because in a

registry system where grantors are identified by personal identification numbers (alphanumeric or other code), the secured creditor should still be identified by its name. However, since the secured creditor identifier is not a search criterion, strict accuracy is not as essential to the effectiveness of the registration.

36. Consequently, under the approach recommended in the *Guide*, an error in the identifier or address of a secured creditor renders the registration ineffective only if it would seriously mislead a reasonable searcher (see recommendation 64). Still, substantial accuracy is always important, since searchers rely on the secured creditor identifier and address information in the registry record for the purposes of sending notices under the secured transactions law (such as a notice of an extrajudicial disposition of an encumbered asset; see recommendations 149-151).

3. Description of encumbered assets

(a) General

37. Under the law recommended in the *Guide*, a description of the assets to which the registration relates is a required component of an effective registration (see recommendation 57, subpara. (b)). In this way, the registration provides objective information to third parties dealing with the grantor's assets (such as prospective secured creditors, buyers, judgement creditors and the insolvency representative of the grantor) and thus enables the grantor to sell or encumber (or further encumber) its assets.

38. In addition, under the law recommended in the *Guide*, a description of the encumbered assets is generally considered sufficient, for the purposes of both an effective security agreement and effective registration, as long as it reasonably identifies the encumbered assets (see recommendations 14, subpara. (d), and 63). Where the security right covers generic categories of a grantor's assets, it may be helpful if the registration rules explicitly confirm that a reference to the relevant category is sufficient (for example, "all of the grantor's movable assets" or "all of the grantor's inventory and receivables"). The rules might also confirm that a generic description is assumed to cover future assets within the specified category unless expressly stated otherwise (for example, a reference to "receivables" would include both present and future receivables).

(b) Supplementary description requirements for "serial number" assets

39. As already explained (A/CN.9/WG.VI/WP.46, paras. 70-72), information in notices submitted to the general security rights registry contemplated by the *Guide* is generally indexed and searched by reference to the identifier of the grantor as opposed to the encumbered asset. This approach reflects two considerations. First, unlike immovable property, most categories of movable asset do not have a sufficiently unique identifier to support asset-based indexing and searching. Second, taking security in future assets and circulating pools of assets such as inventory and receivables would be administratively impractical and prohibitively expensive if the secured creditor had to continuously update its registration to add a description of each new asset acquired by the grantor. A grantor-based indexing system resolves these problems by enabling the secured creditor to make its security right effective against third parties by a single one-time registration covering security rights, whether they exist at the time of registration or are created thereafter, and whether

they arise from one or more than one security agreement between the same parties (see recommendation 68).

40. As compared to asset-based indexing, however, grantor indexing has one drawback. If the grantor sells or disposes of an encumbered asset outside the ordinary course of business, the security right generally will follow the asset into the hands of the transferee (see recommendation 79). Yet the security right will not be disclosed on a search of the registry record against the identifier of the transferee, potentially prejudicing third parties that deal with the asset in the hands of the transferee and that may not be aware of the historical chain of title. Suppose, for example, that grantor B, after granting a security right in its automobile in favour of secured creditor A, sells the automobile to third party C, who in turn proposes to sell or grant security in it to fourth party D. Assuming D is unaware that C acquired the asset from the original grantor B, he or she will search the registry using only C's identifier. That search will not disclose the security right granted in favour of A because it was registered against the name of the original grantor B (on the question whether a secured creditor should be obligated to amend its registration to add the transferee as a new grantor, see A/CN.9/WG.VI/WP.46/Add.2, paras. 5 and 6).

41. In response to the "A-B-C-D" problem, some secured transactions laws provide for asset-based registration and searching in respect of specified categories of tangible asset for which unique and reliable serial numbers or equivalent alphanumerical identifiers are available. For example, the automotive industry assigns a unique alphanumerical identifier, commonly referred to as a vehicle identification number, to identify individual motor vehicles according to a system based on standards originally issued by the International Organization for Standardization (ISO). In States that have implemented this system, the relevant alphanumerical identifier is separately indexed so as to be retrievable by searchers using that identifier, rather than the name of the grantor, as the search criterion. This approach solves the A-B-C-D problem since a serial number search will disclose all security rights granted in the particular asset by any owner in the chain of title.

42. On the other hand, serial number registration and indexing limits the ability of a secured creditor to make a security right effective against third parties in the grantor's future serial number assets through a single registration in which the relevant assets are described simply in generic terms. Instead, the secured creditor will have to effect a new registration (or amend the description of encumbered assets in its existing registration to record the serial number of each new item of serial number assets as it is acquired by the grantor). In light of this problem, serial-number registration and indexing is typically limited to tangible assets for which there is a significant resale market and which have a sufficiently high value to justify the additional legal complexity and reduced flexibility that this approach entails for secured creditors (for example, road vehicles, trailers, mobile homes, aircraft frames and engines, railway rolling stock, boats and boat motors).

43. In addition, in States that have adopted a serial number registration and indexing approach, a generic description in a registration is still sufficient to make a security right effective against third parties generally. Specific serial number registration generally is required only to preserve the secured creditor's right to follow the asset into the hands of a buyer or lessee from the original grantor. In other words, there is no need to include a specific serial number description for the

purposes of achieving third-party effectiveness against other classes of competing claimants, including the grantor's secured and unsecured creditors and insolvency representative. In some States, serial number registration is also necessary for a secured creditor to retain its priority status based on the time of registration against a subsequent secured creditor that takes security in a serial number asset within the generic class covered by the prior secured creditor's registered generic description. However, even in these States, a generic description remains sufficient to achieve third-party effectiveness against the grantor's unsecured creditors and insolvency representative and to preserve priority against a subsequent secured creditor that itself did not include a specific serial number description in its registration.

44. Finally, a serial number description is generally not required where the serial number assets are held by the grantor as inventory. The A-B-C-D problem does not arise in this scenario since buyers that acquire inventory from the original grantor in the ordinary course of the grantor's business take the inventory free of the security right in any event (see recommendation 81, subpara. (a)). Moreover, a generic description of encumbered assets simply as inventory is sufficient to enable searchers to reasonably identify the encumbered assets.

45. The *Guide* discusses but does not recommend the possibility of augmenting the system for making security rights effective against third parties by registration to facilitate the identification of certain encumbered assets (such as motor vehicles) by serial numbers rather than merely by a generic description (see chap. IV, para. 31-36). If a State chooses to augment its secured transactions regime so that serial number registration would be accommodated in the general security rights registry, it must first determine the substantive rules governing serial number assets. In particular, it must provide rules that indicate whether the use of serial numbers (in the security agreement and the notice) is optional or required and, if required, the consequences of failure to use them for serial number assets. Such consequences could range from ineffectiveness of the security right between the parties (if serial number is not included in the security agreement) or ineffectiveness of the security right against third parties to third-party effectiveness but with lower priority (if serial number is not included in the notice). In addition, the registry would need to be designed so that notices have a place for the entry of serial numbers and that the indexing system can index by those serial numbers.

(c) Description of proceeds

46. In the event that the encumbered assets are disposed of by the grantor, the secured transactions regime contemplated by the *Guide* allows the secured creditor to claim an automatic security right in the identifiable proceeds of disposition (see recommendation 19 and the term "proceeds" in the introduction to the *Guide*, sect. B). In this case, the question arises as to whether the third-party effectiveness of the security right in the original encumbered assets automatically extends to the security right in the proceeds or whether the secured creditor needs to take additional steps to ensure that its security right in the proceeds is effective against third parties.

47. When the proceeds consist of cash proceeds (for example, money or a right to payment), the *Guide* recommends the automatic continuation of the third-party effectiveness of a prior registered security right in the original encumbered assets into the proceeds. The same is true where the proceeds are of a type that is already

covered by the description of the original encumbered assets in the registered notice (for example, the description covers "all tangible assets" and the grantor trades in one item of equipment for another; see recommendation 39).

48. However, where the proceeds are not cash proceeds and are not otherwise encompassed by the description in the existing registration, the *Guide* recommends that the secured creditor amend its registration to add a description of the proceeds within a short period of time after the proceeds arise in order to preserve the third-party effectiveness and priority of its security right in the proceeds from the date of the initial registration (see recommendation 40). An amendment of the registration is necessary because a third party otherwise would not be able to identify which categories of asset in the grantor's possession might constitute the relevant proceeds. Accordingly, the registry should be designed in such a way that allows the secured creditor in such situations to register an amendment notice to cover the type of asset represented by the proceeds.

(d) Asset description and impact of error

(i) General

49. As registrations in a general security rights registry are indexed and searched by reference to the grantor's identifier, modern secured transactions regimes along the lines of that recommended in the *Guide* provide that a minor error in the description of the encumbered asset does not make the registration ineffective unless it would seriously mislead a reasonable searcher (see recommendation 64). In addition, under the law recommended in the *Guide*, a registrant's failure to include an asset in the description in a registration means that the registration is ineffective only to the extent of the omitted assets and that the security right is still effective against third parties with respect to the encumbered assets that were included in the description in the registration (see recommendation 65).

50. A question may arise as to the appropriate description of the encumbered assets if a registration describes the encumbered assets as a generic category even though the security agreement concluded or contemplated by the parties covers only certain items within that category. For example, the registration may describe the encumbered assets as "all tangible assets" whereas the security agreement to which the registration is intended to relate covers only specified items of equipment. An over-inclusive description facilitates the ability of the parties to enter into new security agreements encumbering additional assets as the grantor's financing needs evolve without the need for a new registration since the secured creditor can rely on the existing registration for both third-party effectiveness and priority purposes. In any case, the registration has to be authorized by the grantor (see recommendation 71). Otherwise, the grantor is entitled to seek an amendment of the description in the registration to accurately reflect the actual range of encumbered assets covered by the security agreement existing between the parties (see recommendations 72 and A/CN.9/WG.VI/WP.46/Add.2, paras 15-19).

(ii) Error in the description of serial number assets

51. In legal systems that provide for serial number registration and searching for certain serial number assets, the serial number constitutes an indexing and search criterion. Accordingly, although the law recommended in the *Guide* does not address

this matter, it would appear that the rules should provide that the test for whether an error in the serial number identifier renders a registration ineffective should be the same as for an error in the grantor identifier. This means that the test should be whether the error would cause the registration not to be retrieved on a search using the correct identifier (see recommendation 58 and paras. 30-33 above).

52. Where the serial number is correctly entered in the registration, but there is an error in the grantor identifier sufficient that the registration would not be retrieved using the correct grantor identifier the question arises whether a third-party searcher should be entitled to place full confidence in either a grantor or a serial number search. The law recommended in the *Guide* does not address this matter. It would seem that, if serial number description was required and a registration could not be retrieved by a search of the registry record under the correct serial number, whether the grantor identifier was correctly entered or not, an error in the serial number entered in the registration could: (a) make the registration ineffective against third parties; or (b) make the registration effective but result in lower priority for the relevant security right. If, however, serial number indexing was optional or supplementary, an error in the serial number would not render a registration ineffective as long as the grantor identified was correctly entered (see para. 45 above).

4. Duration of registration

53. The law recommended in the *Guide* provides that an enacting State may select one of two approaches to the duration of a registration (see recommendation 69). Under the first approach, the secured transactions law must specify that all registrations are subject to a standard statutory term (for example, five years) with the obligation then being cast on the secured creditor to ensure that the registration is renewed before the expiry of that term. Under the second approach, the law must permit secured creditors to self-select the desired term of the registration. In the latter event, entry of the relevant term will be a legally essential component of an effective registration. In legal systems that adopt this second approach, it may be desirable to base registration fees on a sliding tariff related to the length of the registration life selected by the registrant in order to discourage the selection of excessive registration terms. For the same reason, it may also be desirable to allow selection of the duration by the parties only up to a maximum temporal limit, such as, for example, 10 years (see chap. IV, para. 88).

54. In legal systems that adopt the self-selection approach, it would also be desirable to design the registry in a way that permits the secured creditor to easily select the desired term without the risk of inadvertent error, for example, by limiting the choice to whole years from the date of registration. States that adopt the self-selection approach must address the impact on the effectiveness of registration of an incorrect statement by the registrant as to the duration of the registration. The *Guide* recommends that the error should not render the registration ineffective (see recommendation 66).

55. However, this recommendation is subject to the important caveat, namely, that protection should be given to third parties that relied on the incorrect statement (see recommendation 66). This means that where the registrant enters a shorter term than it actually intended, the registration will lapse at the end of the specified term and the security right will no longer be effective against third parties, unless it was made

effective prior to the lapse by some other method (see recommendation 46). While the secured creditor can re-establish third-party effectiveness, it will take effect against third parties only from that point forward (see recommendations 47 and 96). Where the secured creditor specifies a longer term than it actually intended, there appear to be no concerns with protecting third parties. If the security right referred to in the notice has in fact been extinguished (for example, by payment of the secured obligation and termination of any credit commitment), then third-party effectiveness ceases in any event. If, on the other hand, the secured obligation is still outstanding, it is difficult to see how third parties could be prejudiced by relying on the incorrect statement. The registered notice still alerts them to the possibility that a security right may exist and that they can take steps to protect themselves against that risk. As there would be nothing on the registry record to indicate that the secured creditor intended to enter a shorter term, third-party searchers would not in any way be misled by the secured creditor's error in entering a longer term. Consequently, the error in the term mentioned in the registered notice should not invalidate the registration.

5. Maximum amount for which the security right may be enforced

56. Some secured transactions laws require the parties to a security agreement to include in the notice a statement of the maximum monetary amount for which the security right may be enforced. If the maximum amount specified is more than the amount of the obligation actually owed by the grantor at the time of enforcement, the secured creditor is entitled to enforce its security right only up to the amount actually owed. However, in the converse case where the specified maximum amount is less than the amount actually owed, the secured creditor can enforce its security right only up to the specified maximum amount. In effect, in this case, the secured creditor has only the rights of an unsecured creditor with respect to the difference between the amount actually owed and the maximum amount specified in the security agreement and included in the notice.

57. The aim of this approach is illustrated by the following example. An enterprise has an asset with an estimated market value of $100,000. The enterprise applies for a revolving line of credit facility to a maximum amount of $50,000. The creditor is willing to extend the loan on the condition that it obtains a security right in the asset. The grantor is agreeable but since the maximum loan amount is only $50,000 and the asset has a value of $100,000, the grantor would like to reserve the ability to obtain another secured loan from another credit provider later by giving a security right in the same asset relying on this additional $50,000 in value. Ordinarily, the first-to-register priority rule would deter this subsequent creditor from giving a second loan for fear that the first lender would extend later advances beyond the initial $50,000 for which it would have priority under the general first-to-register rule. By imposing a requirement to specify the maximum value for which the first-registered security right may be enforced, the subsequent secured creditor in this example can be assured that the first-registered secured creditor cannot enforce its security right for an amount greater than $50,000, leaving the residual value of $50,000 available to satisfy its own claim should the grantor default.

58. Other secured transactions laws do not require that a statement of the maximum amount for which the security right may be enforced be included in the notice. This approach is based on the assumptions that: (a) the first secured creditor

is either the optimal long-term financing source or will be more likely to extend financing, especially to small, start-up businesses, if it knows that it will retain its priority with respect to any financing to be provided to the grantor in the future; (b) the grantor will not have sufficient bargaining power to require the first-registered secured creditor to enter a realistic maximum amount in the registered notice (instead the secured creditor will insist that an inflated amount be included to cover all possible future extensions of credit and the grantor will not usually be in a position to refuse its consent); and (c) a subsequent creditor to whom the grantor applies for financing will be in a position to negotiate a subordination agreement with the first-registered security creditor for credit extended on the basis of the current amount of residual value in the encumbered asset. The concern with this latter approach is that it may limit the grantor's access to credit from sources other than the first secured creditor even when its assets have a residual value in excess of any credit granted or intended to be granted by the first creditor.

59. The *Guide* acknowledges that both approaches have merit and recommends that States adopt the policy that is most consistent with efficient financing practices in each State and, in particular, with the credit market assumptions that underlie each approach (see recommendation 57, subparagraph (d) and chap. IV, paras. 92-97).

60. States that adopt the requirement to specify a maximum amount in the registered notice will need to design the registry so as to address the impact of an error by the registrant in entering the amount. On this issue, in line with the approach taken in States that already have this requirement, the *Guide* recommends that an incorrect statement does not render a registered notice ineffective unless it would seriously mislead a reasonable searcher (see recommendation 64). Again, this recommendation is subject to the caveat that parties that relied on an incorrect statement of the maximum amount should be protected (see recommendation 66). Where the amount stated in the notice is greater than the maximum amount specified in the security agreement, a searcher cannot be misled since its decision to advance funds normally will be based on the amount stated in the registered notice. It should be noted that the grantor is also protected in this situation since it could compel the secured creditor to amend the notice to correct the amount so that the grantor could obtain financing against the residual value of the encumbered asset.

61. However, where the amount stated in the notice is less than the maximum amount agreed to in the security agreement, a searcher could be seriously misled into advancing secured credit on the assumption that it could enforce its security right against any value in the asset in excess of the amount stated in the notice. Similarly, a judgement creditor might be seriously misled into taking enforcement action in the belief that the excess value of the asset above that stated in the notice would be available to satisfy its judgement claim. However, while such an error in stating the maximum amount may seriously mislead searchers as in this example, the error should not render the registration ineffective altogether. The interests of third parties are sufficiently protected by limiting the right of the secured creditor to enforce its security right as against the third party only up to the amount erroneously stated by the secured creditor in the registered notice. The law recommended in the *Guide* does not address this matter, as it would arise only if an enacting State chose to require that statement of the maximum amount be included

in the notice. However, the approach just outlined would appear to be consistent with the approach recommended in the *Guide* with respect to the impact of an error in the description of the encumbered assets (see recommendations 64 and 65).