

Model law on inventory financing – special economic zones

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Introductory note

Below is a model law on inventory financing in special economic zones (SEZ) prepared and released by the Aviation Working Group.

The model law may be used by governments as they see fit.

The model law sets out legal rules facilitating such inventory financing in SEZs which do not permit the recognition of floating security or security over pooled and changing inventory assets.

The model law is not intended for use in modifying law outside of an SEZ or within an SEZ on any item other than inventory financing.

The main reason for the model law is to facilitate the financing by airlines of their spare parts inventories. The model law can be used in new or existing SEZs at or near airports where the airline's spare parts are stored.

As a model law, it can be modified to reflect local or national needs or requirements.

Subject to the delegation to an SEZ, use of the model law, as converted into a positive SEZ law, would allow a *lex specialis* type approach, leaving general law unaffected yet advancing the inventory financing needs of airlines, financings, and other with operations in SEZs.

The model law, at Section 14.2, contemplates that a registry to record notices of security rights be established or designated by an enacting SEZ. That is linked to a first-in-time priority rule, at Section 16. Analysis of the feasibility of a multi-national registry for use by any SEZ using the model law is being undertaken.

See next page for the model law

MODEL LAW ON INVENTORY FINANCING – SPECIAL ECONOMIC ZONES

INDEX

Clause	Page
Section 1 Scope of application and general provisions.....	1
1 Scope of application	1
2 Definitions and rules of interpretation	1
3 Party Autonomy	2
Section 2 Creation of a security right.....	3
4 Creation of a security right and requirements for a security agreement.....	3
5 Obligations that may be secured	3
6 Assets that may be encumbered	3
7 Description of encumbered inventory and secured obligations.....	3
8 Rights to proceeds and commingled assets.....	3
9 Security over pools of assets	3
10 Extinguishment of security rights.....	4
11 Contractual limitations on the creation of security rights in receivables	4
Section 3 Effectiveness of a security right against third parties.....	4
12 Primary methods for achieving third-party effectiveness.....	4
13 Proceeds.....	4
Section 4 The registry system and priority	5
14 Establishment of the Registry	5
15 Basic features of Registry.....	5
16 Priority.....	5
17 Knowledge of existing security rights	5
Section 5 Priority and enforcement of a security right.....	5
18 Security rights competing with rights of buyers or other transferees, lessees or licensees of encumbered inventory.....	5
19 Impact of a debtor's insolvency on the priority of a security right.....	6
20 Subordination.....	6
21 Remedies.....	6
Section 6 Final clauses.....	7
22 Conflict of laws	7
23 Further implementing rules	7

SECTION 1

SCOPE OF APPLICATION AND GENERAL PROVISIONS

1 SCOPE OF APPLICATION

- 1.1 This Law applies to security rights in inventory (including associated receivables) within the special economic zone.
- 1.2 The objective of this Law is to:
- (a) facilitate the provision of inventory financing by providing enabling rules for the creation, priority and enforcement of fixed and floating security within the special economic zone;
 - (b) set out the principles for the establishment or designation of a registry to determine priority of the security within the special economic zone; and
 - (c) ensure that the property interest established in fixed and floating security in the special economic zone will be effective when the *lex situs* relating thereto is referred to and applied by courts and tribunals outside of the special economic zone.
- 1.3 This Law will apply in the special economic zone and shall override any conflicting civil or commercial laws of the state within which the special economic zone is situated.

2 DEFINITIONS AND RULES OF INTERPRETATION

For the purposes of this Law:

"competing claimant" means a creditor of a debtor or other person with rights in encumbered inventory that may be in competition with the rights of a secured creditor in the same encumbered inventory.

"debtor" means a person that owes payment or other performance of a secured obligation;

"default" means the failure of a debtor to pay or otherwise perform a secured obligation and any other event that constitutes a default under the terms of an agreement between the debtor and the secured creditor;

"encumbered inventory" means inventory that is subject to a security right;

"future asset" means inventory or a receivable, which does not yet exist or which a debtor does not yet have rights in or the power to encumber at the time the security agreement is concluded;

"interested persons" means:

- (a) a debtor; and
- (b) any person having rights in or over encumbered inventory;

"inventory" means tangible assets which:

- (a) are leased by a person as lessor;
- (b) are held by a person for sale or lease or to be furnished under a contract for the provision of services;

- (c) are furnished by a person under a contract for the provision of services; or
- (d) consists of raw materials, work in process, or materials used or consumed in a business.

"knowledge" means actual or constructive knowledge;

"notice" means a communication in writing;

"priority" means the right of a person in encumbered inventory and proceeds therefrom in preference to the right of a competing claimant;

"proceeds" means whatever is received in respect of encumbered inventory, including what is received as a result of a sale or other transfer, lease, licence or collection of encumbered inventory, civil and natural fruits, insurance proceeds, claims arising from defects in, damage to or loss of encumbered inventory, and proceeds of proceeds;

"receivable" means a right to payment of a monetary obligation;

"registry" means an electronically searchable public registry established or designated by a special economic zone under this Law;

"secured creditor" means a person receiving a security right;

"secured obligation" means an obligation secured by a security right;

"security agreement" means a written agreement, regardless of whether the parties have denominated it as a security agreement, between a debtor and a secured creditor that provides for the creation of a security right;

"security right" means a property right in inventory that is granted by a security agreement to secure payment or other performance of an obligation (including obligations of third parties), regardless of whether the parties have denominated it as a security right, and regardless of the type of asset, the status of a debtor or secured creditor, or the nature of the secured obligation;

"special economic zone" means a designated area that is the subject of special laws and regulations pursuant to binding authority issued by the state in which it is situated;

"state" means an entity so established under international law; and

"writing" includes an electronic communication if the information contained therein is accessible so as to be usable for subsequent reference.

3 PARTY AUTONOMY

- 3.1 The provisions of this Law may be derogated from or varied by agreement, save as provided in clauses 4, 7, 10, 11.2, 12, 13, 21.4, 21.5, 21.10, 21.11 and 22.
- 3.2 This Law allows a secured creditor and debtor to select the law to govern their respective contractual rights and obligations under a security agreement.
- 3.3 This Law allows a secured creditor and debtor to select the forum to resolve disputes under a security agreement and whether such is exclusive or non-exclusive.

SECTION 2

CREATION OF A SECURITY RIGHT

4 CREATION OF A SECURITY RIGHT AND REQUIREMENTS FOR A SECURITY AGREEMENT

- 4.1 A security right is created by a security agreement, provided that a debtor has rights in the asset to be encumbered or the power to encumber it.
- 4.2 A security agreement may provide for the creation of a security right in a future asset, but the security right in that asset is created only when a debtor acquires rights in it and the power to encumber it.
- 4.3 A security agreement must be evidenced by a document that is signed by a debtor and:
- (a) identifies the secured creditor and the debtor;
 - (b) describes the secured obligation; and
 - (c) describes the encumbered inventory.

5 OBLIGATIONS THAT MAY BE SECURED

A security right may secure one or more obligations of any type, present or future, determined or determinable, conditional or unconditional, fixed or fluctuating.

6 ASSETS THAT MAY BE ENCUMBERED

A security right may encumber any type of inventory including without limitation any part or any generic category or other identifiable portion of inventory.

7 DESCRIPTION OF ENCUMBERED INVENTORY AND SECURED OBLIGATIONS

- 7.1 The encumbered inventory and secured obligations shall be described in the security agreement in a manner that reasonably allows their identification.
- 7.2 A description of encumbered inventory that indicates that the encumbered inventory consist of all or a discernible part of a debtor's inventory, or of all or any discernible part of a debtor's inventory within a generic category or specific location, satisfies the standard in paragraph 7.1.
- 7.3 A description of secured obligations that indicates that the security right secures all obligations owed to the secured creditor at any time satisfies the standard in paragraph 7.1.

8 RIGHTS TO PROCEEDS AND COMMINGLED ASSETS

- 8.1 A security right in encumbered inventory extends to its proceeds.
- 8.2 A security right in encumbered inventory continues and is not affected by the encumbered inventory being attached to or combined with another asset.

9 SECURITY OVER POOLS OF ASSETS

- 9.1 This Law allows security rights to be created over a pool of encumbered inventory that change, and continue to be used by a debtor in its ordinary course of business including: (i) disposing of such encumbered inventory free of the security rights without the consent of the secured creditor and (ii) additional assets being added to the pool of encumbered inventory without any further act required from a debtor or the secured party.

9.2

If:

- (a) A debtor becomes subject to insolvency proceedings of any type, including without limitation interim proceedings;
- (b) a winding up order is made in relation to a debtor;
- (c) a receiver, administrative receiver or administrator (or equivalent) is appointed over some or all of a debtor's assets or there is any equivalent step taken to remove a debtor's freedom to deal with its assets;
- (d) a debtor ceases to carry on its business;
- (e) a debtor creates or attempts to create a security right in favour of another creditor over the encumbered inventory;

the security rights over a pool of encumbered inventory will automatically crystallise and a debtor will no longer have any right to continue to use or dispose of such encumbered inventory, which will upon crystallisation form a fixed pool of encumbered inventory.

- 9.3 All of the provisions of this clause 9 can be amended and supplemented by agreement of a debtor and the secured creditor in the security agreement.

10 EXTINGUISHMENT OF SECURITY RIGHTS

A security right is extinguished when all secured obligations have been discharged and there are no outstanding commitments to extend credit secured by the security right.

11 CONTRACTUAL LIMITATIONS ON THE CREATION OF SECURITY RIGHTS IN RECEIVABLES

- 11.1 A security right in a receivable is effective notwithstanding any agreement between the initial or any subsequent debtor and the counterparty of the receivable or any secured creditor limiting in any way a debtor's right to create a security right.
- 11.2 Nothing in this Law affects any obligation or liability of a debtor for breach of the agreement referred to in paragraph 11.1, but the other party to the agreement may not avoid the contract giving rise to the receivable or the security agreement on the sole ground of the breach of that agreement, or raise against the secured creditor any claim it may have as a result of such a breach against a debtor. A person that is not a party to the agreement referred to in paragraph 11.1 is not liable for a debtor's breach of the agreement on the sole ground that it had knowledge of the agreement.

SECTION 3

EFFECTIVENESS OF A SECURITY RIGHT AGAINST THIRD PARTIES

12 PRIMARY METHODS FOR ACHIEVING THIRD-PARTY EFFECTIVENESS

A security right in encumbered inventory is effective against third parties from the date and time when a notice thereof is publicly searchable in the registry.

13 PROCEEDS

If a security right in an asset is effective against third parties, a security right in any proceeds of that asset arising under clause 8 is effective against third parties without any further act.

SECTION 4

THE REGISTRY SYSTEM AND PRIORITY

14 ESTABLISHMENT OF THE REGISTRY

- 14.1 This Law will come into force and take effect thirty (30) days after the special economic zone has established or designated a registry to give effect to the provisions and objectives of this Law relating to the registration of notices with respect to security rights.
- 14.2 The registry so established or designated shall have rules applicable to fees, user access, the mechanics of registration, discharge of registration, and assignment and subordination of registration, and registrar liability and insurance requirements applicable to the registry.

15 BASIC FEATURES OF REGISTRY

- 15.1 The registry will allow for the electronic registration of security rights against debtors.
- 15.2 The written consent of a debtor is required in order to register a security right in an asset of such debtor. The consent shall be given in the security agreement or the other writing between the parties, not through the registry. The consent of a secured creditor is not required.
- 15.3 A registration of a security right must include a description of the encumbered inventory that reasonably allows for its identification.
- 15.4 The registrar of the registry shall ensure the prompt public searchability of a registration, with the date and time of such searchability being recorded and a matter of public record.

16 PRIORITY

Priority between competing security rights in the same encumbered inventory is determined by the order of when notice of each security right registered with the registry is first publicly searchable by any searcher of the registry, without regard to the order of creation of the security rights.

17 KNOWLEDGE OF EXISTING SECURITY RIGHTS

- 17.1 Knowledge of the existence of a security right on the part of a secured creditor will not affect the priority of the security right under this Law.
- 17.2 A buyer, transferee, lessee or licensee who acquires rights in encumbered inventory does so free from any security rights which are not effective against third parties even if it has knowledge of such security right.

SECTION 5

PRIORITY AND ENFORCEMENT OF A SECURITY RIGHT

18 SECURITY RIGHTS COMPETING WITH RIGHTS OF BUYERS OR OTHER TRANSFEREES, LESSEES OR LICENSEES OF ENCUMBERED INVENTORY

- 18.1 If encumbered inventory is sold or otherwise transferred, leased or licensed while the security right in that asset is effective against third parties, the buyer or other transferee, lessee or

licensee acquires its rights subject to the security right except if the secured creditor consents in writing to such transfer, lease or license.

- 18.2 If a secured creditor consents in writing to the sale, transfer, lease or license of encumbered inventory while the security right in that asset is effective against third parties, the buyer or other transferee, lessee or licensee will acquire its rights free of the security right.

19 IMPACT OF A DEBTOR'S INSOLVENCY ON THE PRIORITY OF A SECURITY RIGHT

In insolvency proceedings against a debtor, a security right that is effective against third parties under this Law prior to the commencement of the insolvency proceedings remains:

- (a) effective for all purposes;
- (b) a valid property interest; and
- (c) enforceable notwithstanding any insolvency moratorium.

20 SUBORDINATION

A person may at any time subordinate the priority of its rights under this Law in favour of any existing or future competing claimant. The beneficiary need not be a party to the subordination. Such subordination must be in writing.

21 REMEDIES

- 21.1 In the event of a default, the secured creditor may to the extent a debtor has at any time so agreed, exercise any one or more of the following remedies:
- (a) take possession or control of any encumbered inventory in which it has a security right;
 - (b) sell or grant a lease of any such encumbered inventory; or
 - (c) collect or receive any income or profits arising from the management or use of any such encumbered inventory.
- 21.2 The remedies in clause 21.1 may be exercised without leave of the court and without court action in the special economic zone or the state in which it is situated.
- 21.3 Alternatively, the secured creditor may apply for a court order authorising or directing any of the acts referred to in clause 21.1.
- 21.4 Any remedy set out in clause 21.1 shall be exercised in a commercially reasonable manner. A remedy will be deemed to be exercised in a commercially reasonable manner where it is exercised in conformity with the provisions of the security agreement except where such provision is manifestly unreasonable.
- 21.5 A secured creditor proposing to sell or grant a lease of encumbered inventory under clause 21.1 shall give reasonable prior notice of the proposed sale or lease to a debtor and any competing claimant who has given written notice of their rights to the secured creditor within a reasonable time prior to the sale or lease.
- 21.6 Any sum collected or received by the secured creditor as a result of exercise of any of the remedies set out in clause 21.1 or 21.3 shall be applied towards the discharge of the amount of the secured obligations.
- 21.7 Where the sums collected or received by the secured creditor as a result of the exercise of any remedy set out in clause 21.1 or 21.3 exceed the amount secured by the security right and

any reasonable costs incurred in the exercise of any such remedy, then unless otherwise ordered by a court, the secured creditor shall distribute the surplus among holders of subsequently ranking security rights which have been registered with the registry or which the secured creditor has been given notice of in order of priority, and pay any remaining balance to a debtor.

- 21.8 At any time after a default, the secured creditor and all the interested persons may agree that ownership of (or any other interest of a debtor in) any encumbered inventory shall vest in the secured creditor in or towards satisfaction of the secured obligations.
- 21.9 Alternatively, a court may on the application of the secured creditor order that ownership of (or any other interest of a debtor in) any encumbered inventory shall vest in the secured creditor in or towards satisfaction of the secured obligations.
- 21.10 A court may only grant an application under clause 21.9 if the amount of the secured obligations to be satisfied by such vesting is commensurate with the value of the encumbered inventory after taking account of any payment to be made by the secured creditor to any of the interested persons.
- 21.11 At any time after default and before sale of the encumbered inventory or the making of an order under clause 21.9, a debtor or any interested person may discharge the security right by paying in full the amount secured, subject to any lease granted by the secured creditor under clause 21.1 or ordered under clause 21.3. Where, after such default, the payment of the amount secured is made in full by an interested person other than a debtor, that person is subrogated to the rights of the secured creditor.

SECTION 6

FINAL CLAUSES

22 CONFLICT OF LAWS

- 22.1 This Law is intended as the *lex situs* to govern the creation and effects (including the priority) of security rights in inventory situated in a special economic zone.
- 22.2 This Law excludes renvoi. References to this Law are to its substantive provisions.

23 FURTHER IMPLEMENTING RULES

The governing authority of the special economic zone shall have the power and authority to issue further rules implementing or clarifying the terms of this Law.