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Security Interests

Draft legislative guide on secured transactions

Report of the Secretary-General

Addendum

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* This addendum is submitted five weeks less than the required ten weeks prior to the start of the meeting because the secretariat of the Commission was fully occupied with the preparation of other documents, including another eleven addenda of A/CN.9/WG.VI/WP.2.

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X. Insolvency

A. General remarks

1. Introduction

a. Scope and commercial context

1. This Chapter examines the effects of insolvency proceedings on the enforcement rights of the secured creditor. It should be read together with the UNCITRAL Legislative Guide on Insolvency Law, which addresses the issues identified here in the broader context of insolvency law (see A/CN.9/WG.V/WP.57, A/CN.9/WG.V/WP.58 and A/CN.9/WG.V/WP.61).

2. While a legal system may have distinct regimes for secured transactions and insolvency, both regimes are concerned with debtor-creditor relations, and both encourage credit discipline on the part of debtors. Effective regulation in either area will contribute to positive outcomes in the other. A secured transactions law, for example, may expand the availability of credit, thus facilitating the operation of a business and the avoidance of insolvency. A secured transactions law may also promote responsible behaviour on the part of the creditors to the extent it requires creditors to monitor the ability of debtors to perform their obligations, thereby discouraging over-indebtedness and consequent insolvency.

3. Nevertheless, there are tensions where secured transactions and insolvency law intersect, resulting from the different approaches taken to debt. A secured transactions regime seeks to ensure that certain obligations are met, while an insolvency regime deals with circumstances where obligations cannot be met. In addition, the former regime focuses on effective enforcement rights of individual creditors to maximize the likelihood that the obligations owed are performed. The latter regime, on the other hand, seeks to maximize the return to all creditors by preventing a race between creditors to dismember the assets of their common debtor. These results need to be considered by legislators, reform in one regime can have a wider regulatory effect, imposing unforeseen transaction and compliance costs on stakeholders of the other regime. For this reason, conflicts between the rights and obligations, imposed by the different regimes governing secured transactions and insolvency, should be identified by a country in its law reform process.

4. Insolvency regimes generally contain two main types of proceedings: liquidation (which involves the termination of the commercial business of the debtor, and the subsequent realisation and distribution of the insolvency debtor's assets), and reorganization (designed to maximize the value of assets, and returns to creditors, by saving a business rather than terminating it). In a liquidation proceeding, the insolvency representative is entrusted with the task of gathering the insolvency debtor's assets, selling or otherwise disposing of them, and distributing the proceeds to the debtor's creditors. To maximize the liquidation value of these assets, the representative may continue the debtor's business for a short time and may sell the business as a going concern rather than selling individual assets separately. In a reorganization proceeding, on the other hand, the assumption is that the insolvency debtor's business will continue as a going concern. Thus, the goal of the proceedings is to maximize the value of the debtor's business by allowing the debtor to overcome its financial difficulties and resume or continue normal commercial operations.

5. In addition to legislative forms of insolvency proceeding, alternative approaches are evolving (e.g. out-of-court settlements by the creditors of an insolvent debtor). These processes respond to the need to support economic stability by rapid adjustment of the claims of financial institutions, when it is uncertain whether the relevant insolvency institutions can act quickly and effectively.

[*Note to the Working Group: The Working Group may wish to take into account in its deliberations that Working Group V (Insolvency Law) is considering these alternative approaches (see A/CN.9/507 and A/CN.9/WG.V/WP.61/Add.1).*]

b. Terminology

[*Note to the Working Group: The Working Group may wish to consider whether these definitions should be moved to Chapter I (see A/CN.9/WG.VI/WP.2/Add.1)*.]

6. This Chapter uses the following terms in the sense indicated:

Insolvent debtor	An "insolvent debtor" is a person [or entity] engaged in a business and which meets the criteria for, and is subject to, insolvency proceedings; an insolvent debtor may be either the "debtor" or the "grantor" as those terms are used in this Guide.
Insolvency proceedings	"Insolvency proceedings" are collective proceedings which involve the [partial or total] divestment of the insolvent debtor and the appointment of an insolvency representative [for the purpose of either liquidation or reorganization of the business] [including both liquidation and reorganization proceedings].
Insolvency representative	An "insolvency representative" is a person [or entity] appointed by the court which is in charge of administering the debtor's estate [and assisting and watching over the management of the business] with a view to either liquidation or reorganization of the business.
Secured claim	A "secured claim" is a claim made in an insolvency proceeding, secured by a security right.

2. Key objectives

[*Note to the Working Group: The Working Group may wish to consider whether the discussion of these key objectives should be included in Chapter I (see A/CN.9/WG.VI/WP.2/Add.1)*.]

7. Legislation addressing the rights of a secured creditor when insolvency proceedings have been commenced against its debtor or grantor should be aimed at facilitating enforcement, establishing clear priority rules and recognizing party autonomy (see A/CN.9/WG.VI/WP.2/Add.1, sections D, E and G).

8. If a security right is valid outside insolvency proceedings so that it is effective not only against the debtor but also against third parties, the validity of the security right should be recognized in the insolvency proceeding. Similarly, if a security right has priority over the claim of another creditor outside the insolvency proceeding, the commencement of an insolvency proceeding should not alter the relative priority of these claims. Any exceptions should be limited to the extent possible and be clear and transparent to allow potential financiers to estimate the risk of non-payment and thus the cost involved in a transaction (see also objective 7 in A/CN.9/WG.V/WP.57, para. 21).

9. The secured transactions and insolvency regimes should be co-ordinated in regulating the enforcement of security rights. As already noted (see A/CN.9/WG.VI/WP.2/Add. 9, para. 4), the secured creditor will take into account any limitation of its rights in an insolvency proceeding when assessing whether to advance credit to a debtor and at what cost. In addition, other creditors will have an incentive to commence insolvency proceedings when the debtor is in financial difficulty so as to limit the secured creditor's rights and increase the likelihood of their claims against the debtor being successful.

10. Most legal systems recognize party autonomy in private agreements. There may, however, be public policy reasons for restricting a secured creditor's ability to enforce a security right in some circumstances when insolvency proceedings have been commenced against the debtor. In such cases, certainty is needed. The more predictable these limitations are, and the more the economic value of the security right is preserved, the less adverse will be the impact on the credit enhancement otherwise provided by the use of security rights.

3. Security rights in insolvency proceedings

a. The inclusion of encumbered assets in the insolvency estate

11. An initial question is whether the secured creditor's security right is subject to insolvency proceedings or, in other words, whether the encumbered assets are part of the "estate" created when insolvency proceedings are commenced against a debtor (see A/CN.9/WG.V/WP.58, paras. 46-47). The estate is comprised of those assets of an insolvent debtor that are made subject to administration in the insolvency proceedings.

12. Inclusion of encumbered assets within the insolvency estate can give rise to different effects. In many jurisdictions, this will limit a secured creditor's ability to enforce its security right (see para. 16). Any such legislative limitations on commercial agreements will be taken into account by creditors when deciding whether to extend credit to a debtor, and at what cost. Some insolvency laws that

require all assets to be subject to insolvency proceedings in the first instance allow the separation of encumbered assets from the estate where there is proof of harm or prejudice to the secured creditor's right.

13. To allow for an assessment of whether the continuation of the proceedings will maximize the eventual return to creditors overall, an insolvency law may subject the encumbered assets to control within the insolvency proceedings. As a consequence, a secured creditor may be required to surrender possession of the encumbered assets to the insolvency representative. This approach may be taken not only in reorganization proceedings, but also in liquidation proceedings in which the insolvent debtor's business is to continue while assets are liquidated in stages, or there is a likelihood that the business may be sold as a going concern. As it may not be possible to know at the commencement of insolvency proceedings whether it is desirable to continue the business, many insolvency regimes include the encumbered assets in the estate for a limited time period.

14. An insolvency estate will normally include all assets in which the insolvent debtor has a right at the time insolvency proceedings are commenced. In some jurisdictions, assets in which a creditor retains legal title or ownership may be separated from the insolvency estate. Examples include a retention of title by the secured creditor, a financial lease or a transfer of title to the secured party (see Chapter III.A.3). In other jurisdictions in which these types of legal devices are assimilated with other forms of secured credit arrangements into a general category of "security right", title-based and other security rights are treated in the same way even in insolvency proceedings. This issue is an example of where it may be necessary to co-ordinate the approaches taken in the secured transaction and insolvency regimes.

15. Some secured creditors will participate in insolvency proceedings because they have both a secured and an unsecured claim. This is not limited to situations where the creditor has two separate obligations, only one of which is secured. It also occurs when the secured creditor is under-secured (i.e. the value of the encumbered assets is less than the amount of the secured obligation). In such a case, the secured creditor has a secured claim only to the extent of the value of the encumbered assets and an unsecured claim for the difference (see also section A.3.b).

b. Limitations on the enforcement of security rights

16. Many insolvency laws limit the rights of creditors to pursue any remedies or proceedings against the debtor after insolvency proceedings are commenced, through the imposition of a stay or moratorium. The stay may be imposed either automatically, or by court order. A number of jurisdictions extend the stay to both unsecured and secured creditors. The same reasons for including encumbered assets within the estate apply to the stay of enforcement of security rights. Limitations, however, on a secured creditor's ability to enforce its security right may have an adverse impact on the cost and availability of credit. An insolvency law must balance these competing interests (see A/CN.9/WG.V/WP.58, paras. 69-82).

17. With few exceptions (see para. 13), the need to stay enforcement of a security right is less compelling when the insolvency proceeding is a liquidation proceeding. In most liquidation proceedings, the insolvency representative will dispose of assets individually rather than by selling the business as a going concern. Different approaches may be taken to account for this. For example, an insolvency regime

may exclude secured creditors from the application of the stay, but encourage negotiations between the insolvent debtor and the creditors prior to commencement of the insolvency proceedings to achieve the best outcome for all parties. An alternative approach would provide that the stay lapses after a brief prescribed period of time (e.g. 30 days) unless a court order is obtained, extending the stay on grounds specified in the insolvency law. These grounds might include a demonstration that there is a reasonable possibility the business will be sold as a going concern; this sale will maximize the value of the business; and secured creditors will not suffer unreasonable harm.

18. A stronger case for a stay is made when the insolvency proceeding is a reorganization proceeding. The objective of such a proceeding is to restructure a potentially economically viable entity so as to restore the financial well being and viability of the business, and to maximize the return to creditors. This may involve restructuring the finances of the business by such means as debt forgiveness, debt rescheduling, debt-equity conversions, and sale of all or part of the business as a going concern. Removal of encumbered assets from the business will often defeat attempts to continue the business and sell it as a going concern. Accordingly, an insolvency law might extend the application of a stay to secured creditors for the time period necessary to formulate and present a reorganization plan to creditors.

19. If an enforcement action by a secured creditor is stayed, an insolvency regime should provide safeguards to protect the economic value of the security rights. Such safeguards might include court orders for cash payments for interest on the secured claim, payments to compensate for the depreciation of the encumbered assets and extension of the security right to cover additional or substitute assets.

20. In addition, an insolvency law might also relieve a secured creditor from the burden of a stay by authorizing the insolvency representative to release the encumbered assets to the secured creditor. Grounds for such a release might include cases where the encumbered assets are of no value to the estate and are not essential for the sale of the business, cases where it is not feasible or is overly burdensome to protect the value of the security right.

21. Where the value of the encumbered assets is greater than the secured claim, the insolvency estate has an interest in the surplus. In the absence of insolvency, the secured creditor would have to account to the grantor for the surplus proceeds. If the same assets are disposed of during insolvency proceedings, the surplus would be available for distribution to other creditors. As to who should dispose of the encumbered assets, an insolvency law should address the question whether the same policies that apply outside of insolvency should apply also in insolvency proceedings. For example, if the secured transactions law authorizes the secured creditor to dispose of an asset outside insolvency, the question is whether the secured creditor, rather than the insolvency representative, should control disposition of the relevant encumbered assets during insolvency.

c. Participation of secured creditors in insolvency proceedings

22. If secured creditors are required to participate in insolvency proceedings, the insolvency regime should ensure that participation is effective to protect the interests of secured creditors (see A/CN.9/WG.V/WP.58, paras. 199-203). For example, the notification to creditors announcing the commencement of insolvency

proceedings should indicate whether secured creditors need to make a claim and, if so, to what extent.[1]

23. In addition, if an insolvency law provides for creditor committees to advise the insolvency representative, the law should provide for adequate representation of the interests of secured creditors. Secured creditor representatives may sit on a committee with representatives of unsecured creditors or, alternatively, the law might provide for a separate committee for secured creditors. Concerns that the interests of secured creditors might dominate proceedings to the detriment of other creditors, might be addressed by limiting the issues on which secured creditors may vote. For example, voting might be restricted to the selection of the insolvency representative and matters directly affecting encumbered assets or the economic value of security rights.

d. The validity of security rights and avoidance actions

24. In general, a security right valid outside of insolvency should be recognized as valid in an insolvency proceeding. However, a challenge to the validity of a security interest in insolvency proceedings should be on the same grounds that any other claim might be challenged. Many jurisdictions allow an insolvency representative, for example, to set aside ("avoid") or otherwise render ineffective any fraudulent or preferential transfer made by the insolvency debtor within a certain period before the commencement of insolvency proceedings. The granting or transfer of a security interest is a transfer of property subject to these general provisions, and if that transfer is fraudulent or preferential, the insolvency representative should be entitled to avoid or otherwise render ineffective the security right. This would mean that a security right, which is valid under the secured transaction regime of a jurisdiction, may be invalidated, in certain circumstances, under the insolvency regime of the same jurisdiction (see A/CN.9/WG.V/WP.58, paras. 124-151).

e. The relative priority of security rights

25. A secured transaction regime will establish the priority of claims to encumbered assets (see Chapter VII). Insolvency laws may affect that priority (see A/CN.9/WG.V/WP.58, paras. 217-233). Many laws, for example, give a priority to claims for unpaid wages and employee benefits, environmental damage and Government taxes ("privileged claims"). While most legal systems award these claims priority only over unsecured claims, some regimes extend the priority to rank ahead of even secured claims. It is desirable, however, that these types of exceptions to the first priority of secured creditors be limited as the greater the uncertainty regarding the number and amounts of such claims, the greater will be the negative impact on the availability and cost of credit.

[*Note to the Working Group: The preceding paragraph focuses on the relative priority of secured and preferential creditors. Where insolvency laws do alter the pre-insolvency ranking of secured and unsecured creditors upon insolvency, unsecured creditors may have an incentive to commence insolvency proceedings. While this should be balanced against the corresponding incentive on secured creditors to monitor debtors, there will be a need for safeguards, in such regimes, to prevent abuse of the insolvency regime as a debt collection method by unsecured*

[1] For notification to foreign creditors, see article 14 of the UNCITRAL Model Law on Cross-Border Insolvency and paras. 106-111 of the Guide to Enactment of the Model Law.

creditors. The draft Legislative Guide on Insolvency Law does not recommend any alteration of the relative priority of secured creditors as against unsecured creditors. The Working Group may wish to consider whether to include discussion on this point in the draft Legislative Guide on Secured Transactions.]

26. The insolvency representative may incur costs in the maintenance of encumbered assets and pay for these costs from the general funds of the insolvency estate. Because such expenditure preserves the economic value of the security right, not to grant priority over the secured creditor for these administrative expenses would unjustly enrich the secured creditor to the detriment of the unsecured creditors. To discourage unreasonable expenditure, however, an insolvency law might limit the priority to the reasonable cost of foreseeable expenses.

27. An insolvency representative may be authorized to grant creditors that extend credit to the insolvency estate a security right in assets already encumbered by a security right created before commencement of the insolvency proceedings. The question arises here whether post-commencement secured creditors should be able to obtain priority over the rights of existing secured creditors. In legal systems where this type of priority is recognized, it is rarely given without the consent of the secured creditors that would be subordinated (see A/CN.9WG.V/WP.58, paras. 187-190).

[*Note to the Working Group: The Working Group may wish to consider elaborating in greater detail on the priority of post-commencement financing, including the minimum conditions that may be acceptable for granting a post-commencement secured creditor priority over an existing secured creditor.*]

f. Reorganization plans

28. The principal objective of reorganization proceedings is to maximize the value of the debtor's business (and the return to creditors) by formulating a plan for its rescue (see A/CN.9/WG.V/WP.58, paras. 261-286). A stay of proceedings during the formulation of a plan may postpone the exercise of the rights of secured creditors but need not affect their substantive secured rights. Once the plan has been formulated, however, the question arises as to who must approve the plan before it becomes effective (on the approval of the plan by secured creditors, see A/CN.9/WG.V/WP.58, paras. 276-277). Another question is who might be bound by the plan. If secured creditors are not bound by the plan and are entitled ultimately to the full economic value of their security rights, approval by the secured creditors would not be necessary because their rights would not be impaired.

29. However, as reorganization may only be feasible if the secured creditors receive less than the full value of their secured claims, most insolvency regimes require creditors to approve a plan by a certain majority in number and amount of the claims. Some jurisdictions permit secured creditors to vote as a class on a plan that proposes to impair their claims. Although a vote by the class to approve the plan binds the dissenting secured creditors, these regimes usually require that the dissenters receive at least as much as they would receive in a liquidation proceeding.

30. In most insolvency regimes, a court must confirm a proposed reorganization plan. In such jurisdictions, the insolvency law may set out grounds on which a court may reject the plan. These grounds include the likelihood that the proposed plan may not be feasible because secured creditors are not bound by the plan and may

remove essential encumbered assets from the business subject to the plan. In these circumstances, some regimes provide that the court may bind secured creditors to the plan if certain conditions are satisfied. These conditions include ordering measures to provide adequate protection of the economic value of the security right.

[*Note to the Working Group: The Working Group may wish to consider the treatment of security rights in the case out-of-court restructuring taking into account the relevant discussion by Working Group V (Insolvency Law) (see A/CN.9/507, para. 244 and A/CN.9/WG.V/WP.61/Add.1).*]

B. Summary and recommendations

31. A secured transactions regime should establish clear priority rules, facilitate enforcement and recognize party autonomy. Any exceptions should be limited, clear and transparent.

32. In principle, encumbered assets should be included in the insolvency estate. Whether assets that are subject to a retention or transfer of title arrangement (see Chapter III.A.3.) should form part of the estate or not depends on whether such quasi-security devices are assimilated into a general category of security rights or not.

[*Note to the Working Group: The Working Group may wish to consider whether transfer or retention of title arrangements should be assimilated into a general category of security rights*.]

33. If secured creditors are required to participate in insolvency proceedings, the insolvency regime should ensure that participation is sufficiently effective to protect the interests of secured creditors.

34. The distinction between insolvency proceedings designed to liquidate the assets of an insolvency debtor and proceedings designed to rescue the business of the insolvency debtor support different treatment of security rights in those proceedings.

35. With few exceptions (see para. 13), the need to stay enforcement of a security right is less compelling when the insolvency proceeding is a liquidation proceeding than when it is a reorganization proceeding. Application of the stay, its duration, and the grounds for relief from the stay should be adjusted accordingly. In any event, the secured creditors should be provided with safeguards to ensure adequate protection of the economic value of their security rights when their right to enforce their security rights is deferred by the stay.

[*Note to the Working Group: The Working Group may wish to consider whether the same policies for determining who should dispose of the encumbered assets outside of insolvency should generally apply in insolvency proceedings*.]

36. Subject to any avoidance actions, security rights created before the commencement of an insolvency proceeding should be equally valid in an insolvency proceeding.

37. As a general rule, insolvency proceedings should not alter the priority of secured claims prevailing before the commencement of the insolvency proceedings. Certainty and transparency with respect to any necessary exceptions will help limit the negative impact on the availability and cost of credit.

[*Note to the Working Group: The Working Group may wish to consider whether post-commencement financing secured by security rights in already encumbered assets should be given priority over secured creditors with existing security rights in the same assets and if, so, under what conditions*.]