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Security Interests

Recommendations of the draft legislative guide on secured transactions

Note by the Secretariat

Addendum

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Introduction

1. This note includes recommendations taken from the UNCITRAL Legislative Guide on Insolvency Law (the Insolvency Guide), indicated by numbers in parentheses (the numbers reflect the numbers of the Insolvency Guide), and recommendations A-K, which are new and therefore additional to the recommendations in the Insolvency Guide.

2. The recommendations included from the Insolvency Guide are those that specifically address issues relevant to the treatment of secured creditors and their rights in insolvency, as well as those recommendations regarded as necessary to explain that treatment. So, for example, the definition of “assets of the debtor” is included to explain the scope of the insolvency estate formed on commencement of the insolvency proceedings and thus the assets that will be affected by the commencement of those proceedings.



IX. Insolvency

Recommendations

The following definitions are taken from the glossary of the Insolvency Guide (Introduction, paragraph 12):

12. (b) “Assets of the debtor”¹: property, rights and interests of the debtor, including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor’s interests in encumbered assets or in third party-owned assets;

12. (pp) “Security interest”: a right in an asset to secure payment or other performance of one or more obligations.

[Note to the Working Group: The insolvency chapter will need to address other terms used in the Insolvency Guide and the Secured Transactions Guide; the definition of “security interest” and “security right”, for example, differ in the two texts.]

Insolvency Guide recommendations

Key objectives of an efficient and effective insolvency law

(1) In order to establish and develop an effective insolvency law, the following key objectives should be considered:

- (a) Provide certainty in the market to promote economic stability and growth;
- (b) Maximize value of assets;
- (c) Strike a balance between liquidation and reorganization;
- (d) Ensure equitable treatment of similarly situated creditors;
- (e) Provide for timely, efficient and impartial resolution of insolvency;
- (f) Preserve the insolvency estate to allow equitable distribution to creditors;
- (g) Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; and
- (h) Recognize existing creditors rights and establish clear rules for ranking of priority claims.

¹ For the purposes of this chapter, the term “debtor” as used in the recommendations taken from the Insolvency Guide should be read as referring to a person who meets the requirements for the commencement of insolvency proceedings (see Insolvency Guide, part two, chapter I, section A, paras. 1-11 and recommendation 8). Where the security right at issue (which secures the debtor’s obligation) is granted by the debtor, the term “debtor” also refers to the grantor. However, where the security right at issue is granted not by the debtor but by a third party (e.g. on the basis of some contractual arrangement with the debtor), the term “debtor” refers to the third-party grantor, since only in that third-party grantor’s insolvency is the secured creditor a secured creditor with a proprietary right in the encumbered assets. In the insolvency of a non-grantor debtor, the creditor is an unsecured creditor with an unsecured claim against the non-grantor debtor.

(4) The insolvency law should specify that where a security interest is effective and enforceable under law other than the insolvency law, it will be recognized in insolvency proceedings as effective and enforceable.

(7) In order to design an effective and efficient insolvency law, the following common features should be considered:

(a)-(d) ...

(e) Protection of the insolvency estate against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

(f)-(r) ...

Law applicable to validity and effectiveness of rights and claims

(30) The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings should be determined by the private international law rules of the State in which insolvency proceedings are commenced.

Law applicable in insolvency proceedings: lex fori concursus

(31) The insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) should apply to all aspects of the commencement, conduct, administration and conclusion of those insolvency proceedings and their effects. These may include, for example:

(a)-(i) ...

(j) Treatment of secured creditors;

(k)-(n) ...

(o) Ranking of claims;

(p)-(s) ...

Assets constituting the estate

(35) The insolvency law should specify that the estate should include:

(a) Assets of the debtor, including the debtor's interest in encumbered assets and in third party-owned assets;

(b)-(c) ...

Draft additional recommendations

Unitary approach

A. The insolvency law should provide that, in the case of the insolvency proceedings of the grantor, the acquisition financier has the rights and duties of a holder of a security right.

Non-unitary approach

B. [The insolvency law should provide that, in the case of insolvency proceedings with respect to a buyer under a title retention arrangement, a grantor or a financial lessee, the seller, purchase-money lender or financial lessor has the rights and duties of a holder of a security right.] [The insolvency law should provide that, in the case of insolvency proceedings with respect to a buyer under a title retention arrangement, a grantor or a financial lessee, the seller or financial lessor has the rights and duties of a third-party owner of the asset under the UNCITRAL Legislative Guide on Insolvency Law.]

Treatment of assets acquired after commencement

C. Except as provided in [D], the insolvency law should provide that an asset of the estate acquired after the commencement of an insolvency proceeding is not subject to a security right created by the grantor before the commencement of the insolvency proceeding.

D. The insolvency law should provide that an asset of the estate acquired after the commencement of an insolvency proceeding with respect to the grantor is subject to a security right created by the grantor before the commencement of the insolvency proceeding to the extent the asset is proceeds (whether cash or non-cash) of an encumbered asset which was an asset of the grantor before the commencement of the proceeding.

Insolvency Guide recommendations

Provisional measures

(39) The insolvency law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor or the interests of creditors, between the time an application to commence insolvency proceedings is made and commencement of the proceedings, including:

(a) Staying execution against the assets of the debtor, including actions to make security interests effective against third parties and enforcement of security interests;

(b)-(d) ...

Measures applicable on commencement

(46) The insolvency law should specify that, on commencement of insolvency proceedings [add: a, b, c, d, e]:

(a) Commencement or continuation of individual actions or proceedings concerning the assets of the debtor, and the rights, obligations or liabilities of the debtor are stayed;

(b) Actions to make security interests effective against third parties and to enforce security interests are stayed;

(c) Execution or other enforcement against the assets of the estate is stayed;

(d) The right of a counterparty to terminate any contract with the debtor is suspended; and

(e) The right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.

Draft additional recommendation

Effectiveness of security rights in insolvency

E. The insolvency law should provide that, if a security right was effective against third parties at the time of the commencement of insolvency proceedings, action may be taken after the commencement of the insolvency proceedings to continue, preserve or maintain the effectiveness against third parties of the security right to the extent and in the manner permitted under the secured transactions law.²

Insolvency Guide recommendations

Duration of measures automatically applicable on commencement

(49) The insolvency law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout those proceedings until:

(a) The court grants relief from the measures;

(b) In reorganization proceedings, a reorganization plan becomes effective; or

(c) In the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires, unless it is extended by the court for a further period on a showing that:

(i) An extension is necessary to maximize the value of assets for the benefit of creditors; and

(ii) The secured creditor will be protected against diminution of the value of the encumbered asset in which it has a security interest.

Protection from diminution of the value of encumbered assets

(50) The insolvency law should specify that, upon application to the court, a secured creditor should be entitled to protection of the value of the assets in which it has a security interest. The court may grant appropriate measures of protection that may include:

(a) Cash payments by the estate;

(b) Provision of additional security interests; or

² See footnote to recommendation 46(b) of the Insolvency Guide, which provides that: "If law other than the insolvency law permits those security interests to be made effective within certain specified time periods, it is desirable that the insolvency law recognize those periods and permit the interest to be made effective where the commencement of insolvency proceedings occurs before expiry of the specified time period. Where law other than the insolvency law does not include such time periods, the stay applicable on commencement would operate to prevent the security interest being made effective."

- (c) Such other means as the court determines.

Relief from measures applicable on commencement

(51) The insolvency law should specify that a secured creditor may request the court to grant relief from the measures applicable on commencement of insolvency proceedings on grounds that may include that:

- (a) The encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;
- (b) The value of the encumbered asset is diminishing as a result of the commencement of insolvency proceedings and the secured creditor is not protected against that diminution of value; and
- (c) In reorganization, a plan is not approved within any applicable time limits.

Power to use and dispose of assets of the estate

(52) The insolvency law should permit:

- (a) The use and disposal of assets of the estate (including encumbered assets) in the ordinary course of business, except cash proceeds; and
- (b) The use and disposal of assets of the estate (including encumbered assets) outside the ordinary course of business, subject to the requirements of recommendations 55 and 58.

Draft additional recommendation

Costs and expenses of maintaining value of the encumbered asset

F. The insolvency law should provide that the insolvency representative is entitled to recover from the value of an encumbered asset reasonable costs or expenses (including overhead as appropriate) incurred by the insolvency representative in maintaining, preserving or increasing the value of the encumbered asset for the benefit of the secured creditor.

Insolvency Guide recommendations

Further encumbrance of encumbered assets

(53) The insolvency law should specify that encumbered assets may be further encumbered, subject to the requirements of recommendations 65, 66 and 67.

Use of third-party-owned assets

(54) The insolvency law should specify that the insolvency representative may use an asset owned by a third party and in the possession of the debtor provided specified conditions are satisfied, including:

- (a) The interests of the third party will be protected against diminution in the value of the asset; and
- (b) The costs under the contract of continued performance of the contract and use of the asset will be paid as an administrative expense.

Ability to sell assets of the estate free and clear of encumbrances and other interests

(58) The insolvency law should permit the insolvency representative to sell assets that are encumbered or subject to other interests free and clear of those encumbrances and other interests, outside the ordinary course of business, provided that:

- (a) The insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;
- (b) The holders are given the opportunity to be heard by the court where they object to the proposed sale;
- (c) Relief from the stay has not been granted; and
- (d) The priority of interests in the proceeds of sale of the asset is preserved.

Use of cash proceeds

(59) The insolvency law should permit the insolvency representative to use and dispose of cash proceeds if:

- (a) The secured creditor with a security interest in those cash proceeds consents to such use or disposal; or
- (b) The secured creditor was given notice of the proposed use or disposal and an opportunity to be heard by the court; and
- (c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

Burdensome assets

(62) The insolvency law should permit the insolvency representative to determine the treatment of any assets that are burdensome to the estate. In particular, the insolvency law may permit the insolvency representative to relinquish burdensome assets following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset, and the asset is not required for a reorganization or sale of the business as going concern, the insolvency law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

Security for post-commencement finance

(65) The insolvency law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on unencumbered assets, including after-acquired assets, or a junior or lower priority security interest on already encumbered assets of the estate.

(66) The law should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation 67.

(67) The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

- (a) The existing secured creditor was given the opportunity to be heard by the court;
- (b) The debtor can prove that it cannot obtain the finance in any other way; and
- (c) The interests of the existing secured creditor will be protected.

Effect of conversion on post-commencement finance

(68) The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority accorded to post-commencement finance in the reorganization should continue to be recognized in the liquidation.

Automatic termination and acceleration clauses

(70) The insolvency law should specify that any contract clause that automatically terminates or accelerates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

- (a) An application for commencement, or commencement, of insolvency proceedings;
- (b) The appointment of an insolvency representative.

(71) The insolvency law should specify the contracts that are exempt from the operation of recommendation 70, such as financial contracts, or subject to special rules, such as labour contracts.

(72) The insolvency law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware where continuation would be beneficial to the insolvency estate. The insolvency law should specify that:

- (a) The right to continue applies to the contract as a whole; and
- (b) The effect of continuation is that all terms of the contract are enforceable.

Performance prior to continuation or rejection

(80) The insolvency law should specify that the insolvency representative may accept or require performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted or required by the insolvency representative prior to continuation or rejection of the contract should be payable as an administrative expense:

- (a) ...
- (b) If the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected

against diminution of the value of those assets and have an administrative claim in accordance with subparagraph (a).

[Note to the Working Group: The commentary will make it clear that rejection of a credit agreement does not terminate the security agreement and does not extinguish the security right.]

Draft additional recommendation

Automatic termination clauses

G. If the insolvency law provides that a contract clause which, upon the commencement of insolvency proceedings or the occurrence of another insolvency-related event, automatically terminates any obligation under a contract or accelerates the maturity of any obligation under a contract, is unenforceable as against the insolvency representative or the debtor, then the insolvency law should specify that such provision does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation to make a loan or otherwise extend credit or other financial accommodations to or for the benefit of the debtor.

Insolvency Guide recommendations

Avoidance of security interests

(88) The insolvency law should specify that notwithstanding that a security interest is effective and enforceable under law other than the insolvency law, it may be subject to the avoidance provisions of insolvency law on the same grounds as other transactions.

Financial contracts

(103) Once the financial contracts of the debtor have been terminated, the insolvency law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

Participation by creditors

(126) The insolvency law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

Right to be heard and to request review

(137) The insolvency law should specify that a party in interest have a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled to:

- (a) Object to any act that requires court approval;
- (b) Request review by the court of any act for which court approval was not required or not requested; and
- (c) Request any relief available to it in insolvency proceedings.

Right of appeal

(138) The insolvency law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

Approval by classes

(150) Where voting on approval of the plan is conducted by reference to classes, the insolvency law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. Different approaches may be taken, including requiring approval by all classes or approval by a specified majority of the classes, but at least one class of creditors whose rights are modified or affected by the plan must approve the plan.

(151) Where the insolvency law does not require a plan to be approved by all classes, the insolvency law should address the treatment of those classes which do not vote to approve a plan that is otherwise approved by the requisite classes. That treatment should be consistent with the grounds set forth in recommendation 152.

Confirmation of an approved plan

(152) Where the insolvency law requires court confirmation of an approved plan, the insolvency law should require the court to confirm the plan if the following conditions are satisfied:

- (a) The requisite approvals have been obtained and the approval process was properly conducted;
- (b) Creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;
- (c) The plan does not contain provisions contrary to law;
- (d) Administrative claims and expenses will be paid in full, except to the extent that the holder of the claim or expense agrees to different treatment; and
- (e) Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking.

Challenges to approval (where there is no requirement for confirmation)

(153) Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the insolvency law should permit parties in interest, including the debtor, to challenge the approval of the plan. The insolvency law should specify criteria against which a challenge can be assessed, which should include:

- (a) Whether the grounds set forth in recommendation 152 are satisfied; and
- (b) Fraud, in which case the requirements of recommendation 154 should apply.

Draft additional recommendation**Valuation of encumbered assets in reorganization proceedings**

H. The insolvency law should provide that, in determining the liquidation value of encumbered assets in a reorganization proceeding, consideration should be given to the use of those assets and the purpose of the valuation. The liquidation value of those assets may be based on their value as part of a going concern.

[Note to the Working Group: The commentary will note that the Insolvency Guide commentary provides the same rule for all assets, see paragraph 66, part two, chapter II, section B.]

Insolvency Guide recommendations*Secured claims*

(172) The insolvency law should specify whether secured creditors are required to submit claims.

*Admission or denial of claims**- Valuation of secured claims*

(179) The insolvency law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion that is unsecured by valuing the encumbered asset.

Secured claims

(188) The insolvency law should specify that secured claims should be satisfied from the encumbered asset in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the insolvency law. To the extent that the value of the encumbered asset is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

Draft additional recommendations**Priority of a security right in insolvency proceedings**

I. The insolvency law should specify that, if a security right is entitled to priority under law other than the insolvency law, that priority continues unimpaired in insolvency proceedings except if, pursuant to the insolvency law, another claim is given priority. Such exceptions should be minimal and clearly set forth in the insolvency law. This recommendation is subject to Recommendation 88 of the Insolvency Guide.

[Note to the Working Group: The commentary will provide examples of exceptions, such as post-commencement priority financings and privileged claims.]

Effect of a subordination agreement in insolvency proceedings

J. The insolvency law should provide that, if a holder of a security right in an asset of the insolvency estate has subordinated its priority unilaterally or by agreement in favour of any existing or future competing claimant, such subordination is binding in insolvency proceedings with respect to the grantor.

[Note to the Working Group: See recommendation 85 (see WP.21/Add.1), which sets forth the general rule on subordination applicable in the absence of insolvency proceedings.]

Impact of insolvency on conflict-of-laws rules

K. The law should provide that, notwithstanding the commencement of an insolvency proceeding, the creation, effectiveness against third parties, priority and enforcement of a security right are governed by the law that would be applicable in the absence of the insolvency proceeding. This recommendation does not affect the application of any insolvency rules, including any rules relating to avoidance, priority, or enforcement of security rights.

[Note to the Working Group: The commentary will clarify the relationship among this recommendation and recommendations 30 and 31 of the Insolvency Guide. The commentary will also explain that this recommendation refers to insolvency rules without regard to whether they are characterized for any purpose as procedural, substantive, jurisdictional or otherwise.]
