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Security Interests**Draft legislative guide on secured transactions****Report of the Secretary-General****Addendum****Contents**

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IX. Insolvency

A. General remarks

1. Introduction

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.63 and Addenda). Conflict of laws issues arising with respect to security rights in insolvency proceedings are discussed in Chapter X.

2. Secured transactions laws and insolvency laws have overlapping concerns and objectives. Both are concerned with debtor-creditor relations and both encourage credit discipline on the part of debtors. Although insolvency regimes typically have additional objectives, such as the preservation of viable enterprises in temporary financial difficulty, both regimes share a common objective of protecting the economic value of security rights. 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 both creditors and debtors by requiring creditors to monitor the ability of debtors to perform their obligations, thereby discouraging over-indebtedness and consequent insolvency. Moreover, a secured transactions law that provides for a public record of security rights will make it easier for an insolvency administrator to determine promptly the legal status of creditors who claim that obligations owed to them are secured.

3. Nevertheless, there are tensions where secured transactions and insolvency law intersect because of the different approaches taken to discharging debts or other obligations. A secured transactions regime seeks to ensure that the value of the encumbered assets protects the secured creditor when the obligations owed to the secured creditor are not satisfied, while an insolvency regime deals with circumstances where obligations owing to all creditors cannot be satisfied. In addition, the former regime focuses on effective enforcement rights of individual creditors to maximize the likelihood that the obligations owed are performed or their economic value realized. The latter regime, on the other hand, seeks to maximize the return to all creditors by preventing a race between creditors to enforce individually their rights against their common debtor. These tensions need to be considered by legislators because development or reform in one regime can impose 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 and reconciled by a country in its law reform process.

4. Insolvency regimes generally provide for 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 all 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, actions by individual creditors against the debtor are usually stayed initially and 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 objective of the proceeding is to continue the debtor's business as a going concern if economically feasible. Most insolvency laws providing for reorganization proceedings take as their premise that the value of the insolvent debtor's business as reorganized will provide a greater return to creditors than if the individual assets of the business were liquidated. Thus, a successful reorganization will capture for the creditors the premium of the business's going concern value over its liquidation value (see A/CN.9/WG.V/WP.63/Add. 12).

5. As a supplement to reorganization proceedings, expedited approaches are evolving that encourage prompt judicial confirmation in a formal reorganization proceeding of an agreement reached by the principal creditors or classes of creditor before an insolvency proceeding commences (e.g. reorganizations dealing only with certain classes of debt, such as financial debt). These approaches respond to the need to support economic stability by rapid adjustment of the claims of financial institutions and reduce the cost and delay of the reorganization proceedings (see paras 42-45).

2. Key objectives

6. Legislators revising existing security rights laws or introducing a new secured transactions regime should reconcile proposed legislation with existing or proposed insolvency laws. To implement broad economic and social policies (e.g. protecting workers or preserving supply markets), an insolvency regime may adopt rules that modify rights of secured creditors. This is most notable in regimes that provide for reorganization proceedings. For example, insolvency laws that provide for reorganization of an insolvent debtor's business will often permit the insolvency representative to continue to use encumbered assets in the business to be reorganized. Secured creditors will, however, factor in these potential limitations on their rights to enforce their security rights when making their decision to extend credit. Modifications of the secured creditors' rights will therefore come at the cost of restricting the economic benefits of an effective secured transactions regime. Any modification should therefore be based on articulated policies and the insolvency law should set out the modifications in clear and predictable terms.

7. As a general rule, the validity and relative priority of a security right should be recognized in an insolvency proceeding. If a security right is valid outside insolvency proceedings so that it is effective 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 right of another creditor outside the insolvency proceeding, the commencement of an insolvency proceeding should not alter the relative priority of this security right.

8. Any limitation on the right of a secured creditor to enforce its security right without the secured creditor's consent should preserve as nearly as possible the economic value that a security right had outside the insolvency proceeding. An insolvency regime should therefore provide mechanisms that protect the economic value of the security right.

3. Security rights in insolvency proceedings

a. The inclusion of encumbered assets in the insolvency estate

9. 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.63/Add.5). The estate is comprised of those assets of an insolvent debtor that are subject to administration in and use during the insolvency proceeding.

10. Inclusion of encumbered assets within the insolvency estate can give rise to different effects. In many jurisdictions, inclusion in the estate 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 economic value of the security right or where the particular assets are shown to be fully encumbered and unnecessary to the reorganization process.

11. 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 prohibited from taking possession of encumbered assets or, if it is in possession, 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 at least for a limited time period.

12. An insolvency estate will normally include all assets in which the insolvent debtor has a right at the time insolvency proceedings are commenced. In those jurisdictions where title of the encumbered assets is transferred to the creditor and this is treated as creating a security right (see Chapter III.A.3), the assets are treated as being part of the insolvency estate. The transfer of title to the creditor should, however, be distinguished from the retention of title by the supplier or other purchase-money financier of tangibles. Those jurisdictions that recognize the retention of title do not always include these tangibles within the insolvency estate, whether or not they otherwise assimilate the retention of title to security rights. A jurisdiction may, for example, wish to protect suppliers or other purchase-money financiers from the claims of other creditors when the assets and affairs of their common debtor are liquidated in an insolvency proceeding. Even these jurisdictions might not extend this exclusion to reorganization proceedings because of an overriding policy objective of continuing potentially viable businesses. In any event, this Guide recommends (see A/CN.9/WG.VI/WP.2/Add.5, paras. 11-14 and A/CN.9/WG.VI/WP.2/Add.7, paras. 23-24) that the secured transactions regimes in these jurisdictions should require the suppliers to publicize their interests so that non-purchase money creditors are informed of the suppliers' rights.

[Note to the Working Groups: The Working Groups may wish to consider whether (i) assets transferred to a secured creditor as security or assets in which title is retained by their seller or other purchase-money financier until full payment of the purchase money (see Chapter III, section A.3) and (ii) assets transferred to the insolvent debtor as security or assets sold by the insolvent debtor in which the insolvent debtor has retained title until full payment of their price should be part of the estate.]

13. 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).

14. An insolvency law should provide for the time and manner for determining the economic value of a security right. In principle, the value should be determined as of the time that the insolvency proceeding formally commences. The manner for determining the value will ordinarily be related to the procedure for the recognition of the validity of claims against the debtor's estate (for the variety of possible mechanisms for the admission of claims, including secured claims, see A/CN.9/WG.V/WP.63/Add.13).

15. Outside insolvency, a security agreement may provide that a security right includes the proceeds of encumbered assets and after-acquired assets. An insolvency law should address the issue of whether the secured creditor continues to be entitled to these proceeds and assets acquired after the commencement of insolvency proceedings. Proceeds received on the disposition of encumbered assets in effect are a substitute for those assets and should in principle secure the economic value of the security right. Proceeds in the form of fruits and products of encumbered assets are not literally substitutes but represent natural increases which all parties expect to be subject to the security right. To the extent, however, that the insolvency representative incurs expenses in connection with these proceeds, the secured creditor rather than the estate should ultimately bear the burden of these expenses. Assets acquired by the estate after the commencement of the insolvency proceedings in which the secured creditor might have a right outside insolvency are not substitutes of encumbered assets or the natural fruits or products of those assets. In the absence of new financing by the secured creditor, the case for recognizing the creditor's right in these new assets is less compelling.

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 in the discretion of a court, either on its own motion or on application of an interested party. A number of jurisdictions extend the stay to both unsecured and secured creditors. The same reasons for including encumbered assets within the estate (see para. 13) 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.63/Add.6).

17. Some insolvency laws authorize the court to order protective measures to preserve the estate in the period between a petition to open insolvency proceedings and the court's decision on the petition. These laws typically permit the court to order these protective measures in its discretion, either on its own motion or on application of an interested party. Where these provisional measures are available they may include staying a secured creditor from taking possession of encumbered assets or otherwise enforcing its security right. Because these measures are provisional and are ordered before the decision to commence proceedings, creditors requesting these measures may be required by the court to provide evidence that the measure is necessary and, in some cases, some form of security for costs or damages that may be incurred.

18. With few exceptions (see para. 11), the need to stay enforcement of a security right for a substantial period of time 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 in insolvency proceedings 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. Yet another approach is to leave the lifting of the stay to the discretion of the court supervising the insolvency proceedings but to provide statutory guidelines for the exercise of this discretion (see A/CN.9/WG.V/WP.63/Add.6, paras. 80-83 and 91-92).

19. 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, to maximize the return to creditors, and to maintain employment. This may involve restructuring the finances of the business by such means as debt rescheduling, debt reduction, 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 or to 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, present to creditors and implement a reorganization plan to creditors (see A/CN.9/WG.V/WP.63/Add.6, para. 91).

20. 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 in the encumbered assets. 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. The need for such safeguards is particularly compelling when the encumbered assets are perishable or consumable (such as cash or cash equivalents).

21. 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 or rehabilitation of the business, cases where it is not feasible or is overly burdensome to protect the value of the security right, and cases where the insolvency representative has failed in a timely fashion to sell or abandon the encumbered assets. An insolvency law might also provide that once the stay has been terminated with respect to particular encumbered assets, the secured creditor could use, at its cost and if it wished, procedures in the insolvency proceeding to sell the encumbered assets.

22. Where the value of the encumbered assets is greater than the secured claim, the insolvency estate has an interest in the surplus if the assets are to be liquidated. 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 applicable security rights 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. An insolvency law might provide that, in a liquidation procedure, the encumbered assets would be turned over to the secured creditor if there was a reasonable indication that the secured creditor would sell them more easily and at a better price. In any event, the insolvency law should make clear that any surplus after paying reasonable expenses and satisfying the secured claim should be returned to the insolvency estate.

c. Participation of secured creditors in insolvency proceedings

23. 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.63/Add.11). 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 Secured creditors should have at least the same standing in court proceedings as other creditors.

24. 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 in the context of a single committee 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.

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.

d. The validity of security rights and avoidance actions

25. In general, a security right valid against third parties outside of insolvency should be recognized as valid in an insolvency proceeding. However, a challenge to the validity of a security right in insolvency proceedings should be allowed 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 creation or transfer of a security right 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.63/Add.9). In any event, the insolvency law should set out any grounds for avoidance of a security right in clear and predictable terms. Payment of proceeds after the commencement of insolvency proceedings (see para. 15), should be possible, unless such payment is fraudulent or voidable under other applicable principles.

e. The relative priority of security rights

26. A secured transaction regime will establish the priority of claims to encumbered assets. In exceptional situations, insolvency laws may affect that priority (see A/CN.9/WG.V/WP.63/Add. 14). Many laws, for example, give a priority to one or more of the following classes of claims: 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.

[Note to the Working Groups: The Working Groups may wish to consider adding a new paragraph along the following lines: “Some laws alter the pre-insolvency ranking of secured and unsecured creditors by setting aside a portion of the estate, including encumbered assets, for the benefit of some classes of unsecured creditors, such as employees of the debtor or persons with personal injury claims against the debtor. Some other laws, to discourage egregious conduct by secured creditors before insolvency proceedings commence, provide that in exceptional circumstances the priority of a secured creditor’s security right may be reduced. Examples might include situations in which the secured creditor dictates major decisions by the company prior to the commencement of insolvency proceedings or the secured creditor engages in inequitable conduct prior to the insolvency proceedings relative to the company or its creditors.”]

27. The greater the uncertainty regarding the number and amounts of claims given priority over claims of secured creditors, the greater will be the negative impact on the availability and cost of credit. It is, therefore, essential that exceptions to the priority of secured creditors be limited, in number and monetary amount, and that the existence and amount of these exceptions be expressed in a transparent and predictable way. For example, the exceptions should be set forth, not only in labour or tax law, but also in insolvency and secured transactions law.

28. 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 that directly preserve or protect the encumbered assets. As a general rule, the insolvency law should not subject the value of the encumbered assets to a surcharge for the general administration of the insolvency proceeding. An exception includes the case where the value of the encumbered assets does not meet the full value of the secured creditor's claim, there are no other assets and the secured creditor does not object to the insolvency proceeding.

f. Post-commencement financing

29. In order for an insolvency proceeding to yield the maximum return for all creditors, either through liquidation or reorganization, the insolvency representative must have sufficient funds available to it to fund the expenses of the liquidation or reorganization. In the case of a liquidation, these expenses may include the cost of preserving and protecting the debtor's assets pending their sale or other disposition. In the case of a reorganization, the expenses may include funding payroll and other operating expenses to enable the debtor to carry on its business as a going concern during the insolvency proceeding.

30. In some cases, the insolvency representative may already have sufficient liquid assets to fund such anticipated expenses, in the form of cash or other assets that will be converted to cash (such as anticipated proceeds of receivables). However, these assets may already be subject to valid security rights held by the debtor's pre-existing creditors (such as a lender that has security rights in the debtor's receivables arising as proceeds from the sale of inventory). The use of such assets by the insolvency representative during the insolvency proceeding could well impair, or even destroy, the economic value of such security rights. As a result, an insolvency representative should only be permitted to use such assets in the insolvency proceeding to the extent that the rights of pre-existing secured creditors to receive the economic value of their security rights are protected. Otherwise, prospective secured creditors will be reluctant to extend credit to a debtor knowing that, if the debtor were to become subject to an insolvency proceeding, they could lose the economic value of their security rights as a result of the use of those assets in the insolvency proceeding.

31. In other cases, the insolvency estate's existing liquid assets and anticipated cash flow may be insufficient to fund the expenses of the insolvency proceeding, and the insolvency representative must seek financing from third parties. Such financing may take the form of credit extended to the debtor by vendors of goods and services, or loans or other forms of credit extended by lenders. Often, these are the same vendors and lenders that extended credit to the debtor prior to the insolvency proceeding. Typically, these providers of credit will only be willing to extend credit to an insolvency estate if they receive appropriate assurance (either in the form of a priority claim on, or security rights in, the assets of the insolvent debtor) that they will be repaid. Yet here again, those assets may already be subject to valid security rights held by the debtor's pre-existing creditors and, for the reason described in the preceding paragraph, new creditors asked to extend credit to the insolvency estate should only be given a priority claim or security rights in the insolvent debtor's existing or future assets to the extent that the rights of any pre-existing holders of security rights to receive the economic value are protected.

32. Thus, in any of these financing arrangements (referred to collectively as “post-commencement financing”) it is essential that the economic value of the security rights of pre-existing secured creditors is protected so that the secured creditors will not be unreasonably harmed. If the existing secured creditors’ encumbered assets are of a value significantly in excess of the amount of the secured obligations owing to them, no special protections to the pre-existing secured creditors may be necessary initially (subject to the creditors’ right to ask for protection at a later date if circumstances change). However, in many cases such an excess does not exist, and the pre-existing secured creditors should receive additional protections to preserve the economic value of their security rights, such as periodic payments or security rights in additional assets in substitution for the assets to be used by the insolvency representative or encumbered in favour of a new lender.

33. In providing additional protections to a pre-existing secured creditor, it is likewise important that such creditor not receive greater security rights than it would have been entitled to if there were no post-commencement financing. Thus, the granting of additional security rights should not result in the pre-existing creditor improving its pre-insolvency secured position by, for example, securing pre-insolvency obligations that were unsecured. Rather, any additional security rights granted to a pre-existing secured creditor should secure only the insolvency estate’s obligation to reimburse the secured creditor for the decline in value of the encumbered assets subject to its pre-existing security rights.

34. In some legal regimes, post-commencement financing is governed by specific provisions of the insolvency law, while in other regimes there are no such provisions, and post-commencement financing is extended merely on the basis of a negotiated agreement between the new creditor and the insolvency representative. In both cases, the financing often is extended only after the entry of an order by the insolvency tribunal after a hearing conducted with notice to all affected parties.

35. This Guide recommends that specific provision for post-commencement financing be incorporated into the insolvency law, so that the circumstances in which such financing may be provided, the rules applicable thereto, and the effect of such financing on the rights of all parties may be easily ascertained, and taken into account, by a creditor considering extending credit to a solvent debtor. before an insolvency proceeding is commenced and may be taken into account by the creditor before extending the credit (for further discussion of this topic, see A/CN.9/WG.V/WP.63/Add.14).

g. Reorganization proceedings

36. The principal objective of reorganization proceedings is to maximize the value of the insolvency debtor's business in the interest of all creditors by formulating a plan for the business's rescue as well as to protect investments and preserve employment. In order to achieve these goals, it may be necessary for a secured creditor to participate in the reorganization, especially if the encumbered assets must be used in the insolvency debtor’s business for the business to be able to reorganize and for the insolvency debtor, on emergence from the insolvency proceedings, to conduct its affairs.

37. An important corollary of the secured creditor participating in the reorganization, however, is that the secured creditor should not be made worse off than if the secured creditor resorted to its non-insolvency enforcement rights to

dispose of the encumbered assets and applied the proceeds of the disposition to the secured obligations. Indeed, as a general matter, the economic value of the secured creditor's security rights should be preserved and maintained in the reorganization. Otherwise, the uncertainty created by the inability of the secured creditor to rely upon receipt of the economic value of its security rights in the event of the reorganization of the insolvency debtor in an insolvency proceeding could result in the secured creditor not extending credit to the debtor in the first place or extending the credit at a higher cost. Moreover, such preservation of value is also essential to attract the financing that the insolvency debtor will require in order to implement its reorganization plan and to operate as a rehabilitated enterprise.

38. To be sure, if the secured creditor is to participate in the reorganization, the reorganization plan might contain provisions by which its security rights are proposed to be adversely affected. Even so, the secured creditor may be willing to have its security rights be adversely affected and therefore may agree to be bound by the reorganization plan. However, if the secured creditor does not agree to be bound by the reorganization plan, the question arises as to whether the secured creditor may nevertheless be required to be bound by the reorganization plan over the secured creditor's objection.

39. If under the relevant insolvency law a secured creditor may be required to be bound by the reorganization plan over the secured creditor's objection, the secured creditor should receive the basic protection that the economic value of its security rights should not be diminished under the plan without the consent of the secured creditor. The protection of the secured creditor's security rights should be clear and transparent under the insolvency law so that the secured creditor will be able to make its decision as to whether to extend credit to the grantor and, if so, on what terms, with the certainty of knowing that its security rights will be appropriately protected if the grantor were to become an insolvent debtor and if a reorganization plan were to be adopted for the grantor over the objection of the secured creditor's class or, as the case may be, of the secured creditor itself.

40. There are several examples of ways in which the economic value of the secured creditor's security rights may be preserved in the reorganization plan even though the security rights of the secured creditor are being altered by the plan. If the plan provides that the secured creditor would receive a cash payment under the plan in exchange for the secured obligations, the cash payment should not be less than what the secured creditor would have received had it resorted to its non-insolvency enforcement rights to dispose of the encumbered assets and applied the proceeds of the disposition to the secured obligations. If the plan provides for the secured creditor to release its security rights in some encumbered assets, the plan should provide for substitute assets of at least equal value to become subject to the secured creditor's security rights, unless the remaining encumbered assets have sufficient value to enable the secured creditor to be paid in full upon any disposition or liquidation of the remaining encumbered assets. If the plan subordinates the secured creditor's security rights to those of another secured creditor, the encumbered assets should have sufficient value to enable both the senior and the subordinated secured creditors to be paid in full upon any disposition or liquidation of the encumbered assets. If the plan provides for the amount of the secured obligations constituting a monetary indebtedness to be paid over time, the secured creditor should retain its security rights and the present value of the future payments of the secured obligations, after giving effect to the restructuring of the secured obligations. In addition, the interest rate on the restructured secured obligations provided under the plan, should not be less than the amount that the secured creditor

would have been received had it resorted to its non-insolvency enforcement rights to dispose of the encumbered assets and applied the proceeds of the disposition to the secured obligations.

41. Whether the economic value of the secured creditor's security rights is preserved in a reorganization plan may be more of a factual issue rather than a legal issue in many circumstances. In the event of a contest in the insolvency proceeding as to whether the economic value of the security rights is being preserved under the plan, the determination of value will often require consideration of markets and market conditions. The valuation may, indeed, require expert testimony, especially if the treatment of the secured creditor under the plan involves encumbered assets or securities whose present value may be dependent upon the grantor's future performance and therefore may contain elements of performance risk to be factored into the determination of value. Absent agreement among the contesting parties, the insolvency tribunal will have to decide on the evidence presented whether the economic value of the security rights is being preserved.

h. Expedited reorganization proceedings

42. In recent years, significant attention has been given to the development of expedited reorganization proceedings ("expedited proceedings") as a means of streamlining the reorganization of a debtor, without the cost or delay inherent in formal reorganization proceedings, in situations where all or substantially all of the debtor's major creditors (usually other than trade creditors) are able to reach an agreement as to the terms of the reorganization.

43. Expedited proceedings may take the form of a procedure in which (i) the creditors first conduct negotiations concerning the terms of a proposed reorganization plan prior to the commencement of a formal insolvency proceeding, (ii) a formal insolvency proceeding is then commenced, and (iii) the reorganization plan is presented to the insolvency tribunal for its approval on an expedited basis (but subject to the same requirements for disclosure to, and voting by, all of the debtor's creditors and other procedural requirements that are applicable in formal reorganization proceedings). When approved, the reorganization plan would bind dissenting creditors in the same manner as in a formal reorganization proceeding. (see A/CN.9/WG.V/WP.63/Add.12). However, some proposals for expedited proceedings contemplate less involvement by the insolvency tribunal, and rely primarily on agreements by the major creditors of the debtor, with resort to the tribunal only for limited purposes. Expedited proceedings might also incorporate provisions for obtaining post-commencement financing of the debtor, and an expedited procedure for obtaining judicial review of rulings of the insolvency tribunal.

44. From the perspective of promoting the availability of low-cost secured credit, it is essential that expedited proceedings not frustrate the reasonable expectations of secured creditors, or create a circumstance in which a secured creditor is worse off in such proceedings than it would be in a formal insolvency proceeding. Thus, for example, an expedited proceeding should not, without the secured creditor's consent, deprive that creditor of its ability to realize the full economic value of its encumbered assets, and should reasonably compensate the secured creditor for any diminution in that value resulting from the use of such assets by the debtor during the proceeding. Moreover, the expedited proceeding should not frustrate the reasonable expectations of the secured creditor under its credit documents and applicable law with respect to choice of law or applicable forum.

45. As a general matter, the existence, in a given jurisdiction, of properly constructed expedited proceedings that adhere to the principles discussed above would encourage creditors to extend secured credit in that jurisdiction.

B. Summary and recommendations

46. A secured transactions regime should recognize the right of secured creditors to the economic value of their security rights and maintain the pre-insolvency priority of security rights. Any exceptions should be limited, clear and predictable.

47. In principle, encumbered assets should be included in the insolvency estate.

[Note to the Working Groups: The Working Groups may wish to consider adding a recommendation as to the question whether assets that are subject to a retention or transfer of title arrangement should be part of the insolvency estate (see para. 12 and note)].

48. 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.

49. 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 stays of enforcement of security rights in those proceedings. With few exceptions (see para. 11), 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 in the encumbered assets is deferred for a substantial period of time by the stay.

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

51. 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.

52. An insolvency law should incorporate specific provision for post-commencement financing so that a creditor extending credit to a debtor before an insolvency proceeding is commenced may take into account the possibility of post-commencement financing before extending the credit (see A/CN.9/WG.V/WP.63/Add.14).

53. Expedited proceedings should not frustrate the reasonable expectations of secured creditors, or create a circumstance in which a secured creditor is worse off in such proceedings than it would be in a formal insolvency proceeding.