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Report of Working Group V (Insolvency Law) and Working Group VI (Security Interests) on the work of their second joint session (New York, 26 and 29 March 2004)

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I. Introduction: Summary of the previous deliberations of the Working Groups

1. At its thirty-fifth session (2002), the Commission noted with satisfaction the efforts undertaken by Working Groups V (Insolvency Law) and VI (Security Interests) towards coordinating their work on the treatment of security interests in insolvency proceedings and endorsed a suggestion that the two working groups proceed on the basis of commonly agreed principles (see A/CN.9/511, paras. 126-127 and A/CN.9/512, para. 88). At the session, the Commission also endorsed a suggestion for closer coordination of the work of the two working groups, including a suggestion to hold joint meetings.[1]

2. At their first joint session (Vienna, 16-17 December 2002), Working Group V and Working Group VI considered the treatment of security rights in insolvency proceedings on the basis of chapter IX, Insolvency, of the draft Legislative Guide on Secured Transactions (A/CN.9/WG.VI/WP.6/Add.5). At that session, the Secretariat was requested to prepare a revised version of chapter IX, Insolvency (see A/CN.9/535, para. 8).

3. At its thirty-sixth session (2003), the Commission expressed its appreciation to Working Groups V and VI for the progress made during their first joint session on matters of common interest and noted with satisfaction the plans for further joint meetings of experts.[2]

4. At its fourth session (Vienna, 8-12 September 2003), Working Group VI considered the revised version of chapter IX (A/CN.9/WG.VI/WP.9/Add.6) and requested the Secretariat to prepare a further revision (see A/CN.9/543, para. 15). At that session, a number of issues relating to the treatment of security interests in the draft Legislative Guide on Insolvency Law were identified (see A/CN.9/543, paras. 79-83). In view of the Commission's request to Working Group V to complete its work on the draft Legislative Guide on Insolvency Law and refer it to the thirty-seventh session of the Commission in 2004 for finalization and adoption, a second joint session of the Working Groups was proposed to further consider the issues identified by Working Group VI.[3]

II. Organization of the session

5. Working Groups V and VI, which were composed of all States members of the Commission, held their second joint session in New York on 26 and 29 March 2004. The session was attended by representatives of the following States members of the Working Group: Austria, Cameroon, Canada, China, Colombia, France, Germany, India, Italy, Japan, Mexico, Russian Federation, Singapore, Spain, Sudan, Sweden, Thailand, United Kingdom of Great Britain and Northern Ireland and United States of America.

6. The session was attended by observers from the following States: Argentina, Australia, Belarus, Belgium, Czech Republic, Denmark, Ghana, Holy See, Ireland, Madagascar, Mongolia, Netherlands, Nigeria, Oman, Philippines, Poland, Qatar, Republic of Korea, South Africa, Switzerland and Turkey.

7. The session was also attended by observers from the following international organizations: (a) organizations of the United Nations system: International Monetary Fund (IMF), World Bank, World Intellectual Property Organization (WIPO); (b) intergovernmental organizations: Asian Development Bank, European Bank for Reconstruction and Development (EBRD), International Association of Insolvency Regulators (IAIR); (c) non-governmental organizations: American Bar Association (ABA), American Bar Foundation (ABF), Centre for International Legal Studies (CILS), Commercial Finance Association, Groupe de réflexion sur l'insolvabilité (GRIP), International Bar Association (IBA), International Chamber of Commerce (ICC), INSOL International, International Insolvency Institute (III), International Law Institute, International Working Group on European Insolvency Law, Max Planck Institute of Foreign and Private International Law, European Law Students Association (ELSA) and Union Internationale des Avocats (UIA).

8. The Working Groups elected the following officers:

Chairman: Alexander R. Markus (Switzerland, in his personal capacity)

Rapporteur: Carlos Sánchez-Mejorada y Velasco (Mexico)

9. The Working Groups had before them a note by the Secretariat: "Treatment of security interests in the draft Legislative Guide on Insolvency Law" (A/CN.9/WG.V/WP.71); and the draft Legislative Guide on Insolvency Law (A/CN.9/WG.V/WP.70, parts I and II).

10. The Working Groups adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Consideration of the treatment of security interests in insolvency proceedings.
4. Other business.
5. Adoption of the report.

III. Summary of deliberations and decisions

11. The Working Groups considered the treatment of security interests in the draft Legislative Guide on Insolvency Law (the "draft Guide") on the basis of document A/CN.9/WG.V/WP.71, focusing on the issues set forth in paragraph 7 of that document. The deliberations and decisions of the Working Groups with respect to those issues are set forth below.

IV. Consideration of the treatment of security interests in insolvency proceedings

A. Application of the stay and avoidance provisions to the perfection of a security interest

12. As a preliminary matter, it was observed that, while recommendation 34 of the draft Guide included a specific reference to perfection of security interests, there was no discussion of perfection in the commentary to the draft Guide and it was suggested that such a discussion could usefully be added. It was also observed that use of the term "perfection" might need to be reconsidered and a broader description such as that in square brackets in recommendation 34 (b) "actions to make security interests effective against third parties" or a description referring to "publicity requirements" adopted.

13. With respect to the desirability of including perfection within the scope of the stay, the view was expressed that if law other than the insolvency law permitted perfection within certain specified time limits or grace periods (as referred to in footnote 35 to para. 189 of A/CN.9/WG.V/WP.70), those periods might need to be recognized by the insolvency law, permitting perfection of a security interest after the commencement of insolvency proceedings, but within the specified grace period. Where law other than the insolvency law did not include such grace periods, the stay applicable after commencement of insolvency proceedings would operate to prevent perfection. That approach was widely supported. In addition, it was observed that the question of whether an act of perfection in insolvency would make a security interest effective against third parties should be distinguished from the issue of whether or not perfection was permitted. Under one law, for example, a security interest perfected after commencement would be of no effect in liquidation, while it could be effective in reorganization. It was also observed that the effect in insolvency might depend upon what the act of perfection involved. Where, for example, perfection required registration, it might be permitted to occur after commencement of insolvency proceedings, but a different view might be taken of perfection which involved the secured creditor taking possession of an asset, thus reducing the assets available for the estate.

14. With respect to the application of avoidance provisions to perfection, it was generally agreed that such actions should be subject to avoidance in the same manner as other actions discussed in the chapter on avoidance in the draft Guide.

B. Determination of economic value of security interests (especially timing of valuation)

15. It was proposed that the discussion of valuation in paragraphs 210-214 of the draft Guide should include a cross-reference to the chapter on filing and verification of claims, since early filing of secured claims would enable an early determination of the value of those claims, the extent to which they were secured claims and whether or not protection was required.

16. Concern was expressed that as currently drafted, recommendation 39 of the draft Guide did not provide a clear entitlement to protection of the economic value

of the encumbered asset, but rather left the decision on provision of protection up to the discretion of the court. It was stressed that secured creditors needed to know how their interests would be affected by the commencement of insolvency proceedings and, accordingly, that those effects should be set forth clearly in the insolvency law. In particular, they should know that where the economic value of the encumbered asset was affected by the commencement of insolvency proceedings, they would be entitled to some form of protection of the value of that asset. It was also observed that recommendation 39 was limited to those situations where the value of the asset did not exceed the value of the security interest or, if the value eroded, the creditor was likely to become undersecured, but did not address situations where the creditor was oversecured. In the latter situation, it was suggested, creditors might also be entitled to protection, such as by payment of interest. In response, it was stressed that an insolvency law should carefully balance the different interests of the parties to the proceedings. Paying interest to an oversecured creditor, it was contended, might result in that creditor receiving, as a result of insolvency proceedings, an advantage additional to that provided by its security interest and could not be supported.

17. After discussion, it was agreed that, as a general principle, the draft Guide should specify that, upon application to the court, secured creditors should be entitled to protection of the value of the encumbered assets. In providing that protection, the court would have the discretion to choose among the most appropriate measures of protection provided under the insolvency law. It was further agreed that the notion of erosion of value should be limited to erosion caused by the insolvency proceedings, such as where the operation of the stay prevented the secured creditor from exercising its remedies to protect the value of an asset, or where the debtor's use of an asset in the proceedings led to diminution of its value.

C. Treatment of secured creditors in reorganization where they disagree with, or abstain from voting on, the reorganization plan

18. A number of views were expressed with respect to the treatment of secured creditors in reorganization. In particular it was questioned whether, for example, recommendation 138 of the draft Guide was intended to apply to a dissenting member of a class of creditors which voted in support of a plan or to a dissenting class of secured creditors; whether secured creditors were required to vote on a plan that impaired their interests; whether secured creditors could be bound to a plan against their agreement; and how encumbered assets could continue to be used in reorganization. It was noted that the text of the draft Guide contained certain text in square brackets and indicated a number of issues still to be resolved by Working Group V. It was suggested that the discussion in that Working Group take into account the issues raised at the joint session.

D. Derogations from first priority of secured creditors

19. The Working Groups generally approved the commentary and recommendations of the draft Guide as currently drafted.

E. Treatment of subordination agreements

20. A number of questions were raised as to how such agreements would be treated in insolvency proceedings, particularly with respect to classification and priority of subordinated claims. It was observed that these issues could be quite complex and that, since national laws adopted different solutions, addressing them in the draft Guide in any detail would prove difficult. As a general principle, it was agreed that subordination agreements should be respected in insolvency proceedings, provided the parties were not agreeing to a priority higher than would otherwise be accorded under the applicable law, and that the general principle in insolvency of recognizing pre-commencement priorities would include priorities based upon a subordination agreement. As a point of clarification, it was suggested that recommendation 174 of the draft Guide should be limited in its operation to subordination of claims by the court and not apply to contractual subordination. It was also suggested that a third type of subordination, that which resulted from the operation of law, should be mentioned in the draft Guide.

F. Treatment of title arrangements

21. The Working Groups noted that Working Group VI had not reached a final position on the issue of classification of retention of title arrangements, but that for the purposes of the draft Legislative Guide on Secured Transactions, a transfer of title for security purposes was to be treated as a security device. In response to suggestions that the question should be left open in the draft Legislative Guide on Insolvency Law, it was widely agreed that the issue of classification was not one to be resolved by the insolvency law. However, the insolvency law should detail how different types of arrangements would be treated in insolvency proceedings, so that it would be possible to determine, however classified, how a retention of title arrangement would be treated. It was observed that the draft Legislative Guide on Insolvency Law, as currently drafted, did indicate that treatment in a clear and concise matter, addressing constitution of the estate, application of the stay, whether or not different types of arrangements could be included in a reorganization plan, the requirements for continuation of contracts and so on, as indicated in A/CN.9/WG.V/WP.71. It was also noted that the provisions on applicable law set forth in A/CN.9/WG.V/WP.72 were relevant to any discussion of the treatment of title arrangements in insolvency, in that the law applicable to a priority conflict involving a secured creditor could not be different from the law applicable to a priority conflict involving a seller with a retention of title.

22. As a point of clarification, attention was drawn to paragraph 156 of the draft Guide and the definition of the insolvency estate, in addition to the material cited in response to issues 36-39 of A/CN.9/WG.V/WP.71. One proposal was that that definition could perhaps include a specific reference to retention of title arrangements to provide certainty, but after discussion it was agreed that such a reference was not required. It was noted that the terminology used in the insolvency guide, and in particular the word “asset”, might be broader than generally understood as it included property rights and interests, a point which might need to be emphasized in the draft Guide.

Notes

[1] *Official Records of the General Assembly, Fifty-seventh Session, Supplement No. 17* (A/57/17), para. 203.

[2] Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), para. 217.

[3] Ibid., para. 197.