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Draft Legislative Guide on Insolvency Law

Note by the Secretariat: Revisions to A/CN.9/WG.V/WP.70

1. This note sets forth revisions and additions to the commentary in documents A/CN.9/WG/V/WP.70 parts I and II based upon the deliberations of Working Group V at its thirtieth session (see A/CN.9/551 for the report of that meeting).

Introduction

1. Organization and scope of the Guide

1. Add the following to the fifth sentence of paragraph 1 after the words, "emphasis on reorganization":

> "... against a debtor, whether a legal or natural person, that is engaged in economic activity. Issues specific to the insolvency of individuals not so engaged, such as consumers, are not addressed."

2. Add the following to the end of paragraph 1:

> "... to facilitate consideration of cross-border insolvency issues. It should be noted, however, that a model law generally would be used differently to a legislative guide. Specifically, a model law is a legislative text recommended to States for enactment as part of national law, with or without modification. As such, model laws generally propose a comprehensive set of legislative solutions to address a particular topic, and the language employed supports direct incorporation of the provisions of the model law into national law. The focus of a legislative guide, on the other hand, is upon providing guidance to legislators and other users, and for that reason they generally include a

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substantial commentary discussing and analysing relevant issues. It is not intended that the recommendations of a legislative guide be enacted as part of national law as such. Rather, they outline the core issues that it would be desirable to address in that law, with some recommendations providing specific guidance on how certain legislative provisions might be drafted."

3. Add the following to paragraph 2, after the fourth sentence:

"The recommendations adopt different levels of specificity, depending upon the issue in question. A number employ legislative language to detail the manner in which a particular issue should be addressed in an insolvency law, reflecting a high degree of consensus on the particular approach to be adopted. Other recommendations identify key points to be addressed by an insolvency law with respect to a particular topic and offer possible alternative approaches, indicating the existence of different policy and procedural concerns that might need to be considered."

Part One: Designing the key objectives and structure of an effective and efficient insolvency law

II. Mechanisms for resolving a debtor's financial difficulties

4. Add the following introduction before paragraph 31:

"The following discussion focuses upon different mechanisms that have been developed for resolving a debtor's financial difficulties, and have proven to be useful tools for addressing those difficulties. These include proceedings conducted under the insolvency law, whether reorganization or liquidation; negotiations with creditors entered into by the debtor on a voluntary basis and conducted essentially outside of the formal insolvency law; and administrative processes that have been developed in a number of countries to address, specifically, systemic financial problems in the banking sector. The latter have been included simply for information and it is not suggested that they should be developed to address the insolvency of debtors engaged in economic activity. Similarly, the facilitating agency used to supervise these particular administrative processes should not be confused with the authorities, other than judicial authorities, that might be developed to supervise insolvency proceedings concerning economic debtors that are contemplated by the use of the term 'court' in this Guide."

Part Two: Core provisions for an effective and efficient insolvency law

II. Treatment of assets on commencement of insolvency proceedings

D. Post-commencement finance

5. Paragraphs 246-250 should be revised as follows:

3. Attracting post-commencement finance—providing priority or security

246. A number of different approaches can be taken to attracting post-commencement finance and providing for repayment. Trade credit or indebtedness incurred in the ordinary course of business by an insolvency representative (or a debtor in possession) may be treated automatically as an administrative expense. When obtaining credit or incurring indebtedness is essential to maximizing the value of assets and the credit or finance is not otherwise available as an administrative expense or is to be incurred outside the ordinary course of business, the court may authorize that credit or debt to be incurred as an administrative expense, to be afforded super-priority ahead of other administrative expenses or to be supported by the provision of security on unencumbered or partially encumbered assets.

(a) Establishing priority

248. Where the business of the debtor continues to operate after commencement of insolvency proceedings, either incident to an attempted reorganization or to preserve value by sale as a going concern, the expenses incurred in the operation of the business typically are entitled under a number of insolvency laws to be paid as administrative expenses. Administrative priority creditors generally do not rank ahead of a secured creditor with respect to its security interest, but are generally afforded a first priority (see chapter V.B) that will rank ahead of ordinary unsecured creditors and would be paid before any other statutory priorities, for example, taxes or social security claims. Suppliers of goods and services would only continue to supply goods and services to the insolvency representative on credit if they had a reasonable expectation of payment ahead of pre-commencement unsecured creditors. In some cases, this priority is afforded on the basis that the new credit or lending is extended to the insolvency representative, rather than to the debtor, and becomes an expense of the insolvency estate. Some insolvency laws require such borrowing or the incurring of such credit to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary credit or finance without approval, although this may involve an element of personal liability and, where it does, is likely to result in reluctance to seek new finance.

250. Other insolvency laws provide for a "super" administrative priority if credit or finance is not available where ranked as an administrative claim which is *pari passu* with other administrative claims such as fees of the insolvency representative or professional employed in the case. The "super" priority ranks ahead of administrative creditors.

(b) Granting security

247. Where the lender requires security, it can be provided on unencumbered property or as a junior or lower security interest on already encumbered property where the value of the encumbered asset is sufficiently in excess of the amount of the pre-existing secured obligation. In that case, no special protections will generally be required for the pre-existing secured creditors, as their rights will not be adversely affected unless circumstances change at a later time (such as that the value of the encumbered assets begins to diminish) and they will retain their pre-

commencement priority in the encumbered asset, unless they agree otherwise. Frequently, the only unencumbered assets that may be available for securing post-commencement finance will be assets recovered through avoidance proceedings; however providing security on such assets is controversial under some insolvency laws and is not permitted.

249. Some insolvency laws provide that new lending may be afforded some level of priority over existing secured creditors, sometimes referred to as a "priming lien". In countries where this latter type of priority is permitted, insolvency courts recognize the risk to the existing secured creditors and authorize these types of priority reluctantly and as a last resort. The granting of such a priority may be subject to certain conditions such as the provision of notice to affected secured creditors and the opportunity for them to be heard by the court; proof by the debtor that it is unable to obtain the necessary finance without the priority; and the provision of protection for any diminution of the economic value of encumbered assets, including by a sufficient excess in the value of the encumbered asset. In some legal systems, all of the priority, super-priority, security and priming lien options for attracting post-commencement finance are available. As a general rule, the economic value of the rights of pre-existing secured creditors should be protected so that they will not be harmed. If necessary (and as already discussed in relation to protection of the insolvency estate: see chapter II.B.8) this can be achieved by making periodic payments or providing security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending.