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Draft legislative guide on insolvency law

Note by the Secretariat

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[The Introduction and Part One of the draft Guide appear in document A/CN.9/WG.V/WP.63; Part Two, Chapter I appears in documents A/CN.9/WG.V/WP.63/Add.1 and Add.2; Chapter II.A and B appear in documents A/CN.9/WG.V/WP.63/Add.3 and Add.4; Chapter III.A and B appear in documents A/CN.9/WG.V/WP.63/Add.5 and Add.6; Chapter III.D-F and chapters IV-VII appear in subsequent addenda]

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Paragraph numbers in [...] refer to relevant paragraph numbers in A/CN.9/WG.V/WP.58, the previous version of the text of the Guide.

Recommendation numbers in [...] refer to relevant recommendations in A/CN.9/WG.V/WP.61 and A/CN.9/WG.V/WP.61/Add.1, the previous version of the recommendations. Additions to the recommendations are indicated in this document by underlined text.

Part Two (continued)

III. Treatment of assets on commencement of insolvency proceedings

C. Use and disposition of assets

1. Introduction

105. Although as a general principle it is desirable that an insolvency law not unduly interfere with the ownership rights of third parties or those of secured creditors, the conduct of insolvency proceedings will often require assets of the insolvency estate and assets in the possession of the debtor being used in the debtor's business to continue to be used or disposed of in order to enable the goal of the particular proceedings to be realized. This will be especially important in reorganization, but also in liquidation where the business is to be sold as a going concern. It may also be relevant in some cases of liquidation where the business needs to be continued in liquidation for a short period to enable the value of the assets to be maximized even if they are to be sold off piecemeal. For these reasons, it is desirable that an insolvency law include provisions on the use, lease or disposal of assets of the insolvency estate and third party owned assets, addressing the conditions upon which those assets may be used and the provision of protection for the interests of third party owners and the secured creditors.

2. Assets of the insolvency estate

106. With respect to use and disposition of assets of the insolvency estate, some insolvency laws draw a distinction between the exercise of these powers in the ordinary course of conducting the business of the debtor and their exercise other than in the ordinary course of business in terms of who may exercise the powers and the protections that are required. For example, decisions as to sale, use and lease of property in the ordinary course of business may be taken by the insolvency representative without requiring notice to be given to creditors or a hearing of the court. Where the sale, use or lease is not in the ordinary course of business, approval of the court or of the creditors may be required. Some insolvency laws also distinguish between different types of property in terms of how it may be used and the conditions that will apply. Special provisions may be made, for example, with respect to perishable or other assets that will diminish in value if not sold quickly, or for cash, and property held jointly by the debtor and another person.

(a) Methods of sale

107. Where assets of the insolvency estate are to be sold it is important that they are sold in a manner that will maximize the sale price and that creditors receive adequate notice of the sale. Different approaches are taken to achieving this goal. Many insolvency laws require assets to be sold by auction, with some providing that creditors or the insolvency representative can approve some other means of sale if it will be more profitable. Some insolvency laws give the power of sale to the insolvency representative and impose a duty to obtain the best price reasonably obtainable at the time of sale. Some of those laws also impose limits on the insolvency representative's discretion to choose the method of sale. In cases where the insolvency representative chooses to conduct the sale privately rather than through a public auction, the law may require that the court adequately supervise the sale or that the creditors specifically approve it. Other insolvency laws provide for the court to play a significant role in the sale of assets, with the court fixing the time, the form and the conditions of sale; the insolvency representative plays a subsidiary role in collecting offers and obtaining the views of the creditors. Some insolvency laws also address issues such as sales to a creditor to offset that creditor's claim and sale of the debtor's assets in the possession of a third party to that third party for a reasonable market price.

108. Although it may be suggested that an insolvency law should specifically preclude a sale to related parties to avoid collusion, as long as the sale is adequately supervised an absolute prohibition on such a sale may not be necessary.

(b) Sale of secured assets

109. An insolvency law will need to address the question of disposal of secured assets and whether the insolvency representative or the secured creditor will have the power to sell those assets. To a large extent, the approach adopted will depend upon whether the insolvency law includes secured assets in the insolvency estate; if not the secured creditor will generally be free to enforce its security interest. Where secured assets are included in the estate, insolvency laws take different approaches to this issue, which in some cases depends upon the application of other provisions of the insolvency law such as application of the stay and the insolvency representative's ability to sell secured assets free and clear of interests. It may also depend on the nature of the sale proposed, whether as an individual asset or as an integral part of a sale of the business as a going concern. Some insolvency laws, for example, provide that only the insolvency representative will be able to dispose of such assets in both liquidation and reorganization. Some laws distinguish between liquidation and reorganization; only the insolvency representative will be able to dispose of the assets during reorganization, but in liquidation this ability is time limited. After the expiration of the insolvency representative's exclusive period, the secured creditor may exercise its rights. A further approach depends upon the application of the stay; while the stay applies only the insolvency representative can dispose of the assets.

(c) Ability of the insolvency representative to sell free and clear of interests

110. Some insolvency laws provide that the insolvency representative can sell assets of the estate free and clear of interests, including security interests, subject to certain conditions. These may include that the sale is permitted under general law other than the insolvency law, that the interested party consents to the sale, that the sale price is in excess of the value of the interest or that the interested party could be compelled (in other legal proceedings) to accept cash in settlement of its interest. Some laws also provide that where

the interested party does not consent to the sale, the insolvency representative may apply to the court for authorization of the sale. This may be granted provided the court is satisfied, for example, that the insolvency representative has made reasonable efforts to obtain the consent, that the sale is in the interests of the debtor and its creditors and that the sale will not substantially prejudice the interested party.

(d) Joint assets

111. Where assets are owned by the debtor and another person in some form of joint or co-ownership, different approaches may be taken to sale of the debtor's interest. Where the assets can be divided under the general law between the debtor and the co-owners for the purposes of execution, the insolvency estate's interest can be sold without affecting the co-owners. Some insolvency laws, however, provide that both the estate's interest and the interest of co-owners may be sold by the insolvency representative where certain conditions are met. A sale of both interests may be permitted where, for example, division of the property between the estate and the co-owners is impracticable, where the sale of a divided part would realize significantly less for the estate than a sale of the undivided whole free of the interests of the co-owners, and where the benefit to the estate of such a sale outweighs any detriment to the co-owner. The insolvency law may also provide that the co-owner can purchase the debtor's interest before completion of the sale to another party.

(e) Burdensome, no value and hard to realize assets

112. [51] It may be consistent with the objective of maximizing value and reducing the costs of the proceedings to allow the insolvency representative, subject to approval by the court or creditors, to relinquish the estate's interest in certain assets, including land, shares, contracts and other property, provided such relinquishment does not violate any compelling public interest. Situations in which this approach may be appropriate include where assets have a negative or insignificant value; where assets are not essential to a reorganization; where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable.

(f) Surrender of secured assets

113. [80] Where a security is determined to be valid but the secured assets have no value to the insolvent estate, or cannot be realized in a reasonable period of time by the insolvency representative, the insolvency law may allow the insolvency representative to surrender the secured assets to the secured creditor, with or without court approval.

(g) Receivables

114. Where the assets of the estate include receivables (the debtor's contractual right to payment of a monetary sum), it may be advantageous for the insolvency representative to be able to assign the rights to payment to obtain, for example, value for the estate or credit. Different approaches are taken to the question of assignment in the context of insolvency (see Part two, chapter III.D). [111] Some insolvency laws specify that non-assignment clauses are made null and void by the commencement of insolvency proceedings. Other insolvency laws leave the matter to general contract law. If the contract contains a non-assignment clause then the contract cannot be assigned unless the

agreement of the counterparty or of all parties to the original contract is obtained. Some laws also provide that if the counterparty does not consent to assignment, the insolvency representative may assign with permission from the court if it can be shown that the counterparty is withholding consent unreasonably or if the insolvency representative can demonstrate to the counterparty that the assignee can adequately perform the contract. The insolvency representative is then free to assign the contract for the benefit of the estate. This approach is consistent with the approach taken in the UNCITRAL Convention on the Assignment of Receivables in International Trade (2001), article 9.

3. Third party owned assets

115. [48] Complex issues may be raised in determining whether an asset is owned by the debtor or by another party, and whether assets of a third party that are in the possession of the debtor (subject to use, lease or licensing arrangements) at the time of commencement should be included within the assets of the estate (see Part two, chapter III.A.(3)(a) and the discussion on retention of title arrangements). Irrespective of the answer to that question, there will be insolvency cases where third party owned assets, similarly to secured assets, may be crucial to the continued operation of the business, particularly in reorganization proceedings but also to a lesser extent in some liquidation proceedings. In those cases, it will be advantageous for an insolvency law to provide some mechanism which will enable these assets to be used in the insolvency proceedings. Some insolvency laws address this issue in terms of the types of assets to be included within the scope of the insolvency estate. Other insolvency laws, where the possession of the asset by the debtor is subject to a contractual arrangement, address it in the context of the treatment of contracts. This may include, for example, imposing restrictions on the termination of the contract pursuant to which the debtor holds the assets, preventing the owner from reclaiming its assets in the insolvency (at least without the approval of the court or the insolvency representative) and allowing the insolvency representative to continue to use it (see Part two, chapter III.D).

116. [49] Assets subject to a lease agreement which are being used by the debtor as lessee, where the lessor retains legal title, may require special attention. In countries where arrangements allowing the provider of finance to retain title or ownership of the asset as opposed to a mortgage or security interest are of considerable importance, there may be a need to respect the creditor's legal title in the asset and allow it to be separated from the estate (subject to the rules on treatment of contracts: the right to separate may be limited if, for example, the insolvency representative elects to continue the lease contract). By way of comparison, there are also examples of laws which provide for a court-ordered moratorium that prevents third parties from claiming their assets for a limited period of time after commencement. A balance between these two approaches may be desirable, with a view to achieving maximization of value and ensuring that the sale of the business as a going concern or a reorganization will not be rendered impossible by the free separation of the relevant asset. *[Note to the Working Group: This section is to be aligned with the secured transactions guide – see note in Part two, chapter III.A above at para. 66 under Assets to be affected]* There may also be circumstances where these types of financing arrangements should be scrutinized in order to determine whether the lease is, in fact, a disguised secured lending arrangement. In that case the lessor would be subject to the same restrictions in the insolvency proceedings as the secured lender.

117. Where third party owned assets are used in the insolvency proceedings, an insolvency law may also need to consider protection of the interest of the owner of the assets, much in the same way as appropriate protection is provided for secured creditors. It

is desirable that any benefits conferred on the estate by the continued use of the asset be paid for by the estate as an expense of administering the estate. It is also desirable that an insolvency law provide appropriate protection against diminution of the value of third party-owned assets.

Recommendations

Purpose of legislative provisions

The purpose of provisions on use and disposition of assets is to:

- (a) address the manner in which assets may be used and disposed of in the insolvency proceedings, including methods for sale of assets;
- (b) establish the limits to powers of use and disposition;
- (c) provide for the treatment of burdensome assets, assets determined to be of no value to the insolvency estate and assets which cannot be realised in a reasonable period of time by the insolvency representative. ~~abandonment of burdensome assets and for the surrender of unprofitable securities~~

Content of legislative provisions

Assets of the insolvency estate

(43) [(35)] When continued operation of the business of the debtor is authorized under liquidation or reorganization, the insolvency law should:

- (a) permit the insolvency representative to use, sell or lease property assets of the insolvency estate in the ordinary course of business;
- (b) permit the insolvency representative to use, sell or lease ~~property assets of the insolvency estate~~ other than in the ordinary course of business, subject to approval by [the court] [creditors] [and in accordance with recommendations on the use of secured assets and third-party assets].

(44) For the purposes of recommendation (43), the insolvency law should provide that assets subject to security interests¹ can be used by the insolvency representative only where those assets will be of benefit to and are necessary for the conduct of the insolvency proceedings.²

(45) The insolvency law should address protection of the secured creditor where the insolvency representative uses assets subject to a security interest. The benefits conferred upon the insolvency estate by the use of the assets should be payable as an expense of administering the estate and the secured creditor should be entitled to protection against the diminution in value of the security.

¹ Recommendation (27) includes secured assets in the insolvency estate.

² The use of these assets will be subject to other provisions of the insolvency law including on treatment of contracts.

Assets owned by a third party

(46) [(36)] The insolvency law should permit assets owned by a third party that are not part of the insolvency estate but are in the possession of the debtor at the date of commencement to be used by the insolvency representative where those assets will be of benefit to and are necessary for the conduct of the insolvency proceedings.³ Where assets owned by a third party are in the possession of the debtor at the time of commencement, the insolvency law should provide for them to be returned to the third party where they will be of no benefit or value to the insolvency estate.

(47) The insolvency law should address protection of the third party owner of assets where the insolvency representative uses those assets. The benefits conferred upon the insolvency estate by the use of the assets should be payable as an expense of administering the estate and the owner of the assets should be entitled to protection against the diminution in value of the assets.

Burdensome, no value and hard to realize assets

(48) [(37)] The insolvency law should permit the insolvency representative to ~~abandon~~ determine the treatment of any assets that are burdensome⁴ to the insolvency estate or that are not of benefit to the insolvency estate. In particular, the insolvency law may provide for the insolvency representative to relinquish the estate's interest in the assets [subject to approval by the court or creditors].

(49) [(38)] The insolvency law should permit the insolvency representative [subject to approval of the court or creditors] to ~~surrender~~ return to the secured creditor assets subject to a valid security interest where the asset is determined to be a burden to the insolvency estate or is determined to be of no value to the insolvency estate. The insolvency law [should] [may] also provide that where an asset subject to a valid security interest cannot be realised in a reasonable period of time by the insolvency representative, or where there is a reasonable indication that the secured creditor can sell the asset more easily and at a better price, the asset can be returned to the secured creditor.

Methods of sale of assets

(50) [(39)] The insolvency law should provide for methods of sale that will maximize the value of the assets being sold [outside the ordinary course of business] [whether in liquidation or reorganization], permitting both public auctions and private sales and requiring that adequate notice of any sale be provided to creditors. Private sales should ~~may~~ be subject to [supervision] [approval] by the court or approval by creditors.

³ The use of these assets will be subject to other provisions of the insolvency law including on treatment of contracts.

⁴ The insolvency law may establish the circumstances in which an asset may be regarded as burdensome, including [51] where the assets have a negative or insignificant value; where the assets are not essential to a reorganization; where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable.

Ability to sell assets of the insolvency estate free and clear of security interests

(51) [(40)] The insolvency law may permit the insolvency representative to sell assets of the insolvency estate free and clear of any security interest of an entity other than the estate, provided that:

- ~~(a) law other than insolvency law permits such a sale;~~
- ~~(b) the entity consents;~~
- (a) the insolvency representative notifies the secured creditor of its intent to sell the secured asset;
- (b) the secured creditor is given the opportunity to object to the proposed sale;⁵
- (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.

⁵ In the case of a secured creditor, an objection could generally only be sustained on the basis that it could sell the asset for a greater return than the sale proposed by the insolvency representative.