United Nations A/CN.9/WG.V/WP.72

General Assembly

Distr.: Limited
20 January 2004

Original: English

United Nations Commission on International Trade Law
Working Group V (Insolvency Law)
Thirtieth session
New York, 29 March-2 April 2004

Draft legislative guide on insolvency law

Note by the Secretariat

Applicable law in insolvency proceedings

1. At its twenty-ninth session in September 2003, Working Group V (Insolvency Law) discussed applicable law in insolvency proceedings on the basis of document A/CN.9/WG.V/WP.63/Add.17. The Secretariat was requested to reflect the discussion in revising the text of the recommendations on applicable law and to develop a commentary for consideration by the Working Group at its next session. The Secretariat was also requested to consult with the Hague Conference on Private International Law.

2. This note sets forth, for the consideration of the Working Group, a draft commentary on applicable law in insolvency proceedings and a set of revised recommendations developed in consultation with the Hague Conference on Private International Law. This material is intended to replace the existing section D following para. 652 of document A/CN.9/WG.V/WP.70 Part II (and would require appropriate renumbering of the commentary and recommendations of that document).

3. The Working Group may wish to consider the placement of the revised recommendation 179 in the Guide, on the basis that it does not address issues of applicable law (see also recommendation 74(a) in chapter II.F on avoidance).

V.04-50335 (E)

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

V. Management of proceedings

D. Applicable law in insolvency proceedings

1. Introduction

652a. Where insolvency proceedings involve parties or assets located in different States, complex questions may arise as to the law that will apply to questions of validity and effectiveness of rights in those assets or of other claims; and to the treatment of those assets and of the rights and claims of those foreign parties in the insolvency proceedings. In the case of such insolvency proceedings, the forum State will usually apply its private international law rules (or conflict of laws rules) to determine which law is applicable to the validity and effectiveness of a right or claim and to their treatment in the insolvency proceedings. The UNCITRAL Model Law on Cross-Border Insolvency (see chapter VII) does not include harmonized conflict of laws rules for adoption by enacting States, thus leaving these matters to established rules and practices. While insolvency proceedings may typically be governed by the law of the State in which those proceedings are commenced (the *lex fori concursus*), many States have adopted exceptions to the application of that law which vary both in number and scope. The diversity in the number and scope of these exceptions may create uncertainty and unpredictability for parties involved in cross-border insolvency proceedings. By specifically addressing, in a transparent and predictable manner, issues of applicable law an insolvency law can assist in providing certainty with respect to the effects of insolvency proceedings on the rights and claims of parties affected by those proceedings.

2. Law applicable to the creation of rights, entitlements and claims

652b. In a purely domestic setting, insolvency law does not "create" rights (personal or proprietary) or claims, but should respect the rights and claims that have been acquired against the debtor according to other applicable laws, that is civil, commercial, or public law. Insolvency law concerns itself with determining the relative position of each of those rights and claims once insolvency proceedings have commenced and, where appropriate, with establishing the restrictions and modifications to which they will be subject in insolvency proceedings in order to fulfil the collective aims of those proceedings. These limits and restrictions are "insolvency effects" because they arise from the commencement of insolvency proceedings against a debtor.

652c. In the context of cross-border insolvency, it is essential to distinguish between the creation of rights and claims under the law designated as applicable law (whether domestic or foreign substantive law) in accordance with the conflict of laws rules of the forum and the insolvency effects on those rights and claims. Since, as noted, the insolvency law does not establish rights or claims, the issue of whether a given right or claim has been created, and the content of that right or claim, belongs to the realm of general conflict of laws rules. It is typical under general conflict of laws rules, for example, that the law governing the contract will

determine if a contractual claim exists against the insolvent debtor and the amount of that claim; that the *lex rei sitae* will determine if a security interest in immovable assets has been created in favour of a specific creditor, and so on. In this sphere, each State will apply its own conflict of laws rules, including any international conventions in force. In the case of an insolvency proceeding, the forum State will usually apply its conflict of laws rules to determine which law governs the validity and effectiveness of a right or claim before considering the treatment of the right or claim in the insolvency proceedings. It is important to stress that the determination of validity and effectiveness is not an insolvency question, but a matter of other applicable law.

3. Law applicable to insolvency effects—*lex fori concursus*

652d. Once a right or claim is determined to be valid and effective under the law designated as applicable by the conflict of laws rules of the forum, a second issue is the effect of insolvency proceedings on the right or claim—that is, whether it will be recognized and admitted in the insolvency proceedings and, if so, its relative position. This is an insolvency matter. From the conflict of laws point of view, the problem in this second phase lies in determining the law applicable to these insolvency effects. It is quite typical that the law of the State in which insolvency proceedings are commenced, the *lex fori concursus*, will govern the commencement, conduct, administration and conclusion of those proceedings. This would generally include, for example, determining the debtors that may be subject to the insolvency law; the parties that may apply for commencement of insolvency proceedings and the eligibility tests to be met; the effects of commencement, including the scope of application of a stay; the organization of the administration of the estate; the powers and functions of the participants; rules on admissibility of claims; priority and ranking of claims; and rules on distribution. Accordingly, this law generally will govern the insolvency effects over rights and claims validly acquired under foreign law, for example, whether the right or claim, given its nature and conditions, is admissible in the insolvency of the debtor and how it will be ranked.

652e. Problems may arise when the law governing the ranking of a claim and the applicable law other than the insolvency law governing the claim are different. The categories of privileges and priorities that exist and the ranking of claims is always established by the *lex fori concursus*. Normally, when establishing these categories and ranking, the insolvency law of a State takes into account the existence of these claims under the domestic law of the State. However, the claim of a creditor may be constituted in accordance with a foreign law. In that case, it is necessary to determine which claims created under foreign law qualify as equivalent to domestic law claims conferring certain privileges or priorities. In other words, it is necessary to examine whether the kind of claim created under foreign law is “equivalent” to the kind of claim upon which the *lex fori concursus* confers a special status in insolvency proceedings. The test to apply is whether or not both claims, given their essential content and their function, correspond to each other to the extent that they can be considered as “functionally interchangeable”. If the answer is in the affirmative, the claims should be considered as equivalent and receive the same treatment in insolvency proceedings. In the event that equivalence cannot be established, the claim would generally be treated as an ordinary claim.

4. Law applicable to insolvency effects—exceptions to the *lex fori concursus*

652f. To determine the insolvency effects on valid and effective rights and claims, some laws adopt exceptions to the application of the *lex fori concursus*. The purpose of the exception is not to change the law applicable to the question of validity and enforceability (which continues to be governed by the general conflict of laws rules of the forum), but to change the law applicable to the insolvency effects. Instead of applying the *lex fori concursus*, the insolvency effects may be governed, for example, by the same law applicable to the question of validity and effectiveness. For instance, the insolvency effects over a right to set-off may be determined not by the *lex fori concursus*, but by the law applicable to the right of set-off. Other examples of exceptions to the application of the law of the forum that have been adopted by different insolvency laws address the law applicable to payments systems, labour contracts, avoidance provisions, and proprietary rights.

(a) Payment and settlement systems and regulated financial markets

652g. Exceptions to the application of the *lex fori concursus* respond, in general, to certain social policy considerations. Some laws focus, for example, on supporting commercial certainty and reducing risk for the parties engaged in commercial transactions. The parties to a transaction shape their relationships against the background of a specific legal environment, which includes consideration of the degree to which their rights will be protected in the event of the insolvency of the debtor, the most typical risk faced by any creditor. The application of the law under which the right or claim in question was created may be, in general, less costly for the creditor to learn, more predictable in terms of insolvency effects and more difficult for the debtor to manipulate ex-post than the application of the law of the debtor's centre of main interests or domicile. On that basis, it may be argued that it would be reasonable, under certain circumstances, to permit and protect reliance by the parties on the law under which the right or claim was created. A key example relates to payment or settlement systems and regulated financial markets, which many insolvency laws recognize as requiring an exception to the application of the *lex fori concursus*. By applying the law that is applicable to the system or the regulated market, alteration of the mechanisms for payment and settlement in the event of insolvency of a participant can be avoided, thus protecting general certainty and confidence in the system or market and avoiding systemic risk.

(b) Labour contracts

652h. Some laws adopt exceptions to preserve certain rights or interests specially protected by the law of a State from the uncertainties or inconsistencies that may result from the application of the insolvency effects of a foreign *lex fori concursus*. For example, with respect to labour contracts, special (often mandatory) protections may be afforded in terms of a financial safety net for workers, or restrictions on the rejection or modification of those contracts in insolvency. The rationale of such provisions lies in protecting the reasonable expectations of employees with respect to their contract of employment, recognizing that workers may have a relatively weaker bargaining position than their employers, and in ensuring non-discrimination amongst workers working in the same jurisdiction, whether they are employed by a local or by a foreign employer.

(c) Security interests

652i. Some insolvency laws also adopt this approach with respect to security interests. This solution means that the law governing a right *in rem* would determine not only its creation and general validity, but also its effectiveness in the case of insolvency proceedings. In other words, the position of the real security interest in insolvency proceedings commenced abroad will not be established by the *lex fori concursus*, but by the insolvency rules of the law applicable to the security interest. Application of the *lex fori concursus* otherwise may affect the legal framework for secured lending, introducing a factor of instability that may increase the domestic cost of finance. If foreign proceedings intrude upon local security interests, the value of those security interests may be seriously impaired. Similarly, a transfer of the debtor's centre of main interests to a different State can bring about a radical change in the position of the secured party. Rights of set-off may also be subject, as noted above, to law other than the law of the forum, for reasons related to the parties' expectations, especially if they engage in regular dealings with each other.

(d) Avoidance provisions

652j. The rationale of supporting certainty and diminishing risk may also apply to the application of avoidance provisions. Many insolvency laws provide that the law governing the avoidance of transactions should be the *lex fori concursus*, even where, under the general conflict of laws rules of the forum, the transactions to be avoided would be governed by foreign law. Other laws look to the law governing the transaction to also govern avoidance actions relating to the transaction. The policy underlying these exceptions to the application of the *lex fori concursus* protects the counterparty and its reliance on the law governing the transaction. Such an approach may provide counterparties with some degree of certainty and predictability that their transaction with the debtor will not subsequently be subject to attack in insolvency proceedings and assist in reducing the cost of credit and commercial transactions because of the diminished risk of avoidance (which may be essential in the case of transactions taking place in a payment or settlement system).

652k. Some of the laws that look to the law governing the transaction for avoidance actions adopt an approach that combines both the *lex fori concursus* and the law governing the transaction in one of several ways. One approach provides that a transaction will not be subject to avoidance in insolvency unless it is avoidable both under the law of the State in which the insolvency proceedings commenced and the law governing the transaction. A second approach provides that a transaction can be avoided if avoidance can be achieved under either the law of the forum or the law governing the transaction. One law, for example, provides that the law of the forum will apply to avoidance, but recognizes the application of a different law where that different law is stricter than the law of the forum and would lead to avoidance of a wider range of transactions.

5. Achieving a balance between the desirability of exceptions and the goals of insolvency

652l. It is critical that policy considerations that form the basis of an exception to the application of the *lex fori concursus* be weighed against other considerations that are central to insolvency proceedings, in particular the goal of maximizing the value of the insolvency estate for the benefit of all creditors, rather than specific

individual creditors, and treating all similarly-situated creditors equally. The law of the forum will be designed to support the specific goals of insolvency in that jurisdiction and will provide certainty for the insolvency representative in performing many of its functions with respect to the insolvency proceedings, including avoidance of transactions, treatment of contracts, treatment of claims and so on. Its application in insolvency proceedings may avoid potentially costly and extensive litigation to determine issues of applicable law for purposes of insolvency effects, and the validity and effectiveness of rights or claims given the insolvency effects under the law of the forum. Thus, in may circumstances the application of the *lex fori concursus* for insolvency effects may reduce costs and delays and therefore maximize the value of the insolvency estate for the benefit of all creditors. Furthermore, the application of an exception to the *lex fori concursus* for insolvency effects may result in disparate treatment of the insolvency effects on similarly-situated creditors merely because their rights and claims are governed by different applicable law. It may be argued, for example, that the rules of set-off of the forum should be applied to claims on the basis that, in insolvency, rights of set-off are closely related to the proof and quantification of claims and policies governing the equal treatment of creditors. Since these are questions regulated by the law of the forum, the rights of set-off should be similarly regulated.

Recommendations

Purpose of legislative provisions

The purpose of provisions on the applicable law in insolvency proceedings is to:

(a) Facilitate commerce by recognizing, in insolvency proceedings, the rights and claims that arise before commencement of insolvency proceedings and the law that will apply to the validity and effectiveness of those rights and claims;

(b) Establish the law applicable in insolvency proceedings and exceptions, if any, to the application of that law.

Contents of legislative provisions

Recognition of rights and claims arising before commencement

(179) The insolvency law should recognize rights and claims arising under general law, except to the extent of any express limitation in the insolvency law.

Law applicable to validity and effectiveness of rights and claims

(180) 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

(181) 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) Identification of the debtors that may be subject to insolvency proceedings;

(b) Determination of when insolvency proceedings can be commenced and the type of proceeding that can be commenced, the party that can apply for commencement and whether the commencement criteria should differ depending upon the party applying for commencement;

(c) Constitution and scope of the insolvency estate;

(d) Protection and preservation of the insolvency estate;

(e) Use or disposal of assets;

(f) Proposal, approval, confirmation and implementation of a plan of reorganization;

(g) Avoidance of certain transactions;

(h) Treatment of contracts;

(i) Set-off;

(j) Treatment of secured creditors;

(k) Rights and obligations of the debtor;

(l) Duties and functions of the insolvency representative;

(m) Functions of the creditors and creditor committee;

(n) Treatment of claims;

(o) Ranking of claims;

(p) Costs and expenses relating to the insolvency proceedings;

(q) Distribution of proceeds;

(r) Conclusion of the proceedings; and

(s) Discharge.

Exceptions to the application of the law of the insolvency proceedings

(182) Notwithstanding recommendation (179), the effects of insolvency proceedings on the rights and obligations of the participants in a payment or settlement system or in a regulated financial market shall be governed solely by the law applicable to that system or market.

(183) Notwithstanding recommendation (179), the effects of insolvency proceedings on rejection, continuation and modification of labour contracts may be governed by the law applicable to the contract.

(184) Any exceptions additional to recommendations (182) and (183) should be limited in number and be clearly set forth or noted in the insolvency law.