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Security interests

Draft legislative guide on secured transactions

Note by the Secretariat*

Addendum

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XI. Insolvency

A. General remarks

1. Introduction

1. Secured transactions laws and insolvency laws have different concerns and objectives, some of which may overlap where the interests regulated by a secured transactions law are affected by the commencement of insolvency proceedings. A secured transactions law seeks to promote secured credit, i.e. credit at a lower cost, because security lowers the risk of non-payment to the secured creditor ("default"). It allows debtors to use the full value of their assets to obtain credit, develop their businesses and avoid default. In the case of default by a debtor, a secured transactions law seeks to ensure that the value of the encumbered assets protects the secured creditor. It focuses on effective enforcement of the rights of individual creditors to maximize the likelihood that, if the obligations owed are not performed, the economic value of the encumbered assets can be realized to satisfy the obligations. An insolvency law, on the other hand, is principally concerned with collective business and economic issues. It seeks to maximize the return to all creditors, firstly by preventing a race among creditors to enforce individually their rights against a common debtor, and secondly by facilitating the reorganization of viable business enterprises and the liquidation of businesses that are not viable. For these reasons, an insolvency law may affect the rights of a secured creditor. For example, a secured creditor's rights to enforce its security may be postponed upon the commencement of insolvency proceedings.

2. Since reform of one law can impose unforeseen transaction and compliance costs on stakeholders under the other law and create tension between the two laws, legislators revising existing laws or introducing a new law in the field of either insolvency or secured transactions will need to ensure that that new or revised law properly takes account of an existing or proposed law in the other field. In some cases, review of the law in one field may point to the need to revise or develop a new law in the other field. In any event, to the extent that an insolvency law affects the rights of secured creditors, those effects should be based on carefully articulated policies and stated clearly in the insolvency law.

3. The effects of the commencement of insolvency proceedings on security rights are discussed in detail, as a matter of insolvency law, in the *UNCITRAL Legislative Guide on Insolvency Law* (hereinafter the "*Insolvency Guide*"), adopted by UNCITRAL on 25 June 2004.[1] The purpose of this chapter is to highlight, in section A, some of the key points of intersection between an insolvency law and a secured transactions law. To that end, recommendations from the *Insolvency Guide* that relate particularly to security rights are repeated in this Guide. For a more complete discussion of the potential effect of the commencement of insolvency proceedings on security rights, however, this chapter should be read together with

[1] For the decision of the United Nations Commission on International Trade Law and the resolution of the General Assembly (resolution 59/40 of 2 December 2004), see the *UNCITRAL Legislative Guide on Insolvency Law* (United Nations publication, Sales No. E.05.V.10), annex II. The Insolvency Guide, which includes in its annex III the UNCITRAL Model Law on Cross-Border Insolvency and its Guide to Enactment, can be found at www.uncitral.org.

both the commentary and the recommendations of the *Insolvency Guide*. This chapter also includes discussion of several additional recommendations elaborating on issues discussed in the *Insolvency Guide*, but not the subject of recommendations in that Guide. All the recommendations are set out in section B.

2. Terminology

4. The *Insolvency Guide* and the present Guide use a number of defined terms (see *Insolvency Guide*, Introduction, Glossary, and this Guide, Introduction, sect. B, Terminology and rules of interpretation). Section B of this chapter, which includes recommendations, also includes certain definitions taken from the *Insolvency Guide* that are useful for understanding the recommendations of that Guide. For a better understanding of the recommendations of the *Insolvency Guide*, reference should be made to the other definitions in that Guide.

5. Certain terms that are defined in the *Insolvency Guide* are not redefined in this Guide and thus have the same meaning as in the *Insolvency Guide*. However, since, unlike the *Insolvency Guide*, the focus of this chapter is on issues relating to security rights, terms that are redefined in this Guide have the meaning given to them in this Guide (for an exception, see paras. [8] and [9] below).

6. The term "security right" is used in this chapter as defined in this Guide, since the definition of "security interest" in the *Insolvency Guide* is broader in that it refers generally to "a right in an asset to secure payment or other performance of one or more obligations" and accordingly potentially covers security rights in immovable property and non-consensual security rights that are not covered by the definition of "security right" in this Guide (see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

7. Similarly, the term "priority" is used in this chapter as defined in this Guide, since the definition of "priority" in the *Insolvency Guide* is narrower, referring only to the priority of claims in the context of insolvency ("the right of a claim to rank ahead of another claim where that right arises by operation of law"). This Guide defines "priority" as "the right of a person to derive the economic benefit of its security right in an encumbered asset in preference to a competing claimant" (see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). To refer to "priority" in insolvency proceedings, this chapter uses the term "ranking of claims" (see, for example, paras. [60]-[65] below).

8. The term "debtor" is defined in this Guide by reference to the person owing the secured obligation. As that definition would not work well in this chapter, "debtor" in this chapter has the meaning given to the term in the *Insolvency Guide*, that is, a person that meets the requirements for the commencement of insolvency proceedings (see *Insolvency Guide*, part two, chap. I, paras. 1-11, and recommendation 8).

9. In addition, as other chapters of this Guide focus on the term "grantor" (i.e. the person that creates a security right) rather than the term "debtor" (i.e. the person owing the secured obligation), references in this chapter to "debtor" should be understood as meaning "the grantor" in cases where the grantor is a person other than the person owing the secured obligation. This approach is necessary, since only in the third-party grantor's insolvency does the secured creditor have a proprietary right in the encumbered assets. In the insolvency of a non-grantor debtor, the

creditor is an unsecured creditor with an unsecured claim against the non-grantor debtor.

3. General principles concerning security rights in insolvency

10. Consistent with the *Insolvency Guide*, insolvency law should recognize in principle the creation, third-party effectiveness and priority of a security right and post-default rights of a secured creditor, as established under secured transactions law (see recommendations 179 and 180 of this Guide). However, to achieve the goals of insolvency proceedings, the rights that a secured creditor has outside of insolvency proceedings may need to be modified or affected once the insolvency proceedings commence. In such a case, it is desirable that an insolvency law also include appropriate protections for the secured creditor. What is important for the availability of secured credit is that insolvency law contains clear rules as to the effect of insolvency proceedings on the rights of a secured creditor, so as to enable secured creditors to quantify the risks associated with insolvency and incorporate those risks into their assessment of whether to extend credit and on what terms.

4. Applicable law in insolvency proceedings

11. The determination of the law applicable to the creation, third-party-effectiveness and priority of a security right and the post-default rights of a secured creditor may be a complex issue when insolvency proceedings are commenced in one State and some of the debtor's assets or creditors are located in another State, or when insolvency proceedings are commenced in two different States owing to the multinational nature of the debtor's business. In either instance, general private international law rules applying outside of insolvency proceedings would govern these matters. This result is made clear in recommendation 30 of the *Insolvency Guide*, which provides that the State in which insolvency proceedings are commenced (i.e. the forum State) should apply its private international law rules to determine which State's secured transactions law governs such questions as the creation, third-party effectiveness and priority of a security right and post-default rights of a secured creditor outside of insolvency proceedings (see also recommendation 173 of this Guide).

(a) Insolvency effects: *lex fori concursus*

12. Once, under the non-insolvency law applicable outside of insolvency proceedings by virtue of the private international law rules of the forum State, the creation, third-party effectiveness and priority of a security right and post-default rights of a secured creditor are determined, a second issue arises concerning the effect of commencement of insolvency proceedings on security rights. For example, the question arises as to whether enforcement of a security right is stayed and whether the security right will be recognized in the insolvency proceedings and, if so, its relative position. The problem in this second phase lies in determining the law applicable to these insolvency effects. It is generally recognized that the insolvency law of the State in which the insolvency proceedings are commenced (*lex fori concursus*) governs the commencement, conduct, administration and conclusion of the proceedings (the "insolvency effects"). This result is reflected in recommendation 31 of the *Insolvency Guide*.

13. Problems may arise when the insolvency law governing the ranking of the security right changes the relative priority that a security right would have under secured transactions law. The categories of claims that, under insolvency law, would receive distributions ahead of a security right in insolvency proceedings are typically governed by the *lex fori concursus*. When establishing these categories of claims, the insolvency law of a State should look to secured transactions law with regard to the creation, third-party effectiveness, priority and enforcement of the security right before considering the extent, if any, to which the priority of the security right should be affected by the commencement and administration of insolvency proceedings.

(b) Exceptions to the *lex fori concursus*

14. While the insolvency effects of insolvency proceedings on security rights typically are governed by the *lex fori concursus*, some States have adopted exceptions. For example, a forum State may defer to the insolvency law of the State in which immovable property is located (*lex rei sitae*) for the insolvency effects on a security right in attachments to the immovable property. The *Insolvency Guide* addresses these exceptions in more detail (see part two, chap. I, paras. 85-90), but does not recommend the adoption of a *lex rei sitae* rule for insolvency effects as applied to attachments to immovable property or even to movable property in general. Instead, it generally recommends that any exceptions to the applicability of the *lex fori concursus* for insolvency effects should be limited in number and clearly set forth in the insolvency law (see *Insolvency Guide*, recommendation 34 and part two, chap. I, para. 88).

15. The question of the applicable insolvency law is further complicated if the debtor is subject to concurrent insolvency proceedings commenced in different States. In such a case, the court in which one proceeding is pending may defer to the insolvency law of the State in which another proceeding is pending for the insolvency effects on a security right in an encumbered asset located in the other State.

5. Treatment of encumbered assets

16. A security right may be affected following the commencement of insolvency proceedings by the provisions of insolvency law that define the scope of or otherwise address, for example, the assets of the debtor that are subject to the insolvency proceedings, application of a stay or suspension of actions against the debtor, post-commencement finance, avoidance of transactions that took place before commencement of the proceedings, approval of a reorganization plan, and ranking of claims.

(a) Identification of assets subject to the proceedings

17. Identification of assets of the debtor that will be subject to insolvency proceedings is key to the successful conduct of the proceedings. Assets that are controlled by an insolvency representative and subject to the insolvency proceedings form the “estate” (see definition of the term “assets of the debtor” in sect. B below). So, the estate that is formed on commencement of the proceedings will typically include all property, rights and interests of the debtor, including rights and interests in property, whether tangible (movable or immovable) or intangible,

wherever located (domestic or foreign), and whether or not in the possession of the debtor at the time of commencement. The debtor's rights and interests in encumbered assets as well as assets acquired by the debtor or the insolvency representative after commencement of the proceedings and assets recovered through avoidance actions, would typically be included in the estate.

(i) Encumbered assets

18. The inclusion in the estate of the debtor's rights and interests in encumbered assets may assist in ensuring not only the equal treatment of creditors similarly situated, but also the achievement of the goals of the insolvency proceedings where, for example, the asset in question is essential for the reorganization of the debtor or sale of the debtor's business as a going concern. The *Insolvency Guide* discusses the assets of the debtor to be included in the estate (as well as those assets to be excluded) and the effect of commencement of insolvency proceedings on encumbered assets. It emphasizes, in particular, the importance to a successful reorganization of including in the insolvency estate the debtor's interest in encumbered assets and third-party-owned assets (see *Insolvency Guide*, part two, chap. II, paras. 7-9) and of applying a stay on commencement to certain actions with respect to security rights (see *Insolvency Guide*, part two, chap. II, paras. 36-40, 56, 57 and 59-69, and recommendation 46, as well as paras. [25] and [26] below).

(ii) Assets acquired after commencement of insolvency proceedings

19. Consistent with the recommendations of the *Insolvency Guide* (see recommendation 35, subpara. (b)), an asset acquired by the debtor after the commencement of insolvency proceedings generally is part of the insolvency estate.

20. Accordingly, even though the secured creditor may have a security right in future assets of the debtor, the security right should not extend to an asset acquired by the debtor after the commencement of the insolvency proceedings (see also recommendation 176 of this Guide). If the security right did extend generally to an asset acquired by the debtor after the commencement of the insolvency proceedings, the secured creditor would unfairly benefit from the increase in the encumbered assets that could be available to satisfy the secured obligation resulting from the post-commencement acquisition of property by the debtor without the secured creditor providing any additional credit to the debtor. Likewise, other creditors of the insolvency estate would be unfairly prejudiced if unencumbered assets of the insolvency estate were used after the commencement of the insolvency proceedings to acquire additional property and those assets were to become automatically subject to the secured creditor's security right and used to satisfy the secured obligation.

21. However, if the asset acquired by the debtor after the commencement of the insolvency proceedings consists of proceeds of an asset in which a secured creditor had a security right that was effective against third parties before the commencement of the insolvency proceedings (or was made effective against third parties after commencement but within a grace period), the security right should extend to the proceeds (see recommendation 177 of this Guide). If this were not the case, the secured creditor would not have the benefit of its security right in an encumbered asset that is disposed of or collected after the commencement of the insolvency proceedings and, because of that risk, would be less willing to extend

credit at affordable rates to the debtor even where there is no likely prospect of the commencement of the debtor's insolvency proceedings.

22. An example may be helpful in illustrating these points. A secured creditor has an unavoidable security right in all of the debtor's existing and future inventory. After the commencement of insolvency proceedings, the debtor sells immovable property that is not subject to any security right and uses the cash received from the sale to buy inventory. The security right should not extend to this post-commencement inventory. The secured creditor advanced no credit in reliance upon a security right in the new inventory. Permitting the security right to extend to the new inventory would prejudice other creditors of the insolvency estate since the immovable property, an unencumbered asset that was otherwise available to satisfy claims of the other creditors, would have been used to increase the assets available to satisfy the secured obligation. The result would be that the value of the additional inventory would be less likely to be available to satisfy claims of the other creditors even though the value was derived from immovable property that was fully available to satisfy those claims.

23. However, if the additional inventory was acquired with cash received by the debtor from the sale of inventory existing on the commencement of the insolvency proceedings and in which the secured creditor had an unavoidable security right, the security right should extend to the inventory acquired after the commencement of the insolvency proceedings. Before the commencement of the insolvency proceedings the secured creditor had advanced credit to the debtor in reliance upon a security right in the inventory that the debtor sold after the commencement of the insolvency proceedings. The additional inventory is in effect a substitution for the sold inventory. The secured creditor does not benefit unfairly and other creditors are not unfairly prejudiced.

(b) Protection of the estate by application of a stay

24. Two essential objectives of an effective insolvency law are, first, ensuring that the value of the insolvency estate is not diminished by the actions of various parties and, second, facilitating administration of the estate in a fair and orderly manner. Many insolvency laws achieve these objectives by imposing a stay that prevents the commencement of individual or group actions by creditors to enforce their claims or pursue any remedies or proceedings against the debtor or property of the estate and suspends any such actions already under way. Where the stay applies from the commencement of the insolvency proceedings, it can be complemented by provisional measures of relief that can be ordered by the court to ensure protection of the assets of the debtor and the collective interest of creditors between the time when an application to commence insolvency proceedings has been filed and the time it is acted on by the court. The *Insolvency Guide* discusses the scope of actions to which a mandatory or provisional stay applies (see *Insolvency Guide*, part two, chap. II, paras. 30-40); time and duration (including extension) of the stay (see part two, chap. II, paras. 41-53 and 58); and measures to protect the interests of secured creditors (part two, chap. II, paras. 59-69).

(i) Scope of the stay

25. A number of jurisdictions extend the stay to all actions against the debtor, whether judicial or not, including those by secured creditors and third-party owners.

The stay usually extends to actions to enforce a security right by repossessing and selling, leasing or otherwise disposing of the encumbered assets (or exercising another enforcement remedy set out in chapter X, Post-default rights, of this Guide). It also extends to actions to create a security right or to make a security right effective against third parties. Some insolvency laws distinguish between liquidation and reorganization in terms of application and duration of the stay to actions by secured creditors or third-party owners. A growing number of insolvency laws recognize that, notwithstanding that limiting the enforcement of security rights may have an adverse impact on the cost and availability of credit, excluding actions by secured creditors from the stay could frustrate the basic objectives of the insolvency proceedings. This is true particularly in reorganization, since very often the debtor's continued use of encumbered assets is essential to the operation of the business and therefore to its reorganization. Any negative effects of the stay can be ameliorated by measures to ensure that the economic value of the encumbered assets is protected against diminution (see paras. [29]-[31] below).

26. Where a security right was effective against third parties at the time the insolvency proceedings commenced, it is necessary to exempt from the application of the stay any action that the secured creditor might need to take to ensure that effectiveness continues. For example, the secured transactions law may provide a grace period for registration of certain security rights, such as acquisition security rights, in the general security rights registry (see recommendation 189, subpara. (b), of this Guide); the stay generally should not interfere with registration within such a grace period (even if the grace period ends after the commencement of the insolvency proceedings).

(ii) Duration of the stay

27. In reorganization proceedings, subject to the safeguards discussed below it is desirable that the stay applies to secured creditors for a sufficient period of time to ensure orderly administration of the reorganization without encumbered assets being removed from the estate before it can be determined how those assets should be treated and an appropriate plan approved.

28. It is also desirable that the stay applies to secured creditors in liquidation proceedings, in particular to facilitate sale of the business as a going concern. The stay may apply for a short period of time (e.g. 30-60 days) that is clearly set forth in the insolvency law, with provision for an extension in certain circumstances. Alternatively, the stay may apply for the duration of the liquidation proceedings, subject to the court providing relief in certain circumstances (see *Insolvency Guide*, recommendation 49).

(iii) Protection of secured creditors

29. An insolvency law should include safeguards to protect secured creditors where the economic value of their security rights is adversely affected by the stay. One of those safeguards may take the form of relief from the stay or a release of the encumbered asset. Even absent a request for relief from the stay, it is desirable that an insolvency law provides that a secured creditor is entitled to protection against the diminution in value of the encumbered asset and that the court may grant appropriate measures to ensure that protection (see *Insolvency Guide*, recommendation 50).

30. Grounds for relief from the stay or release of the encumbered asset might include cases where, for example, the encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business; the value of the encumbered asset is diminishing as a result of the commencement of the insolvency proceedings and the secured creditor is not protected against that diminution of value; and, in reorganization, a plan is not approved within any applicable time limit. Some insolvency laws also provide that, once relief is granted and the stay has been lifted with respect to particular encumbered assets, the assets may be released to the secured creditor. In such an event, the secured creditor would be free to enforce its security rights under applicable law other than insolvency law. Any surplus value remaining after payment of the secured obligation would be part of the estate.

31. Central to the notion of protecting the value of encumbered assets from diminution is the mechanism for determining both the value of those assets and the time at which valuation takes place, depending upon the purpose for which the determination is required. Assets may need to be valued at different times during the insolvency proceedings, such as at commencement with the value being reviewed during the proceedings, or during the course of the proceedings. The basis on which the valuation should be made is also an issue (e.g. going concern or liquidation value). The value of an encumbered asset may, at least in the first instance, be determined by pre-commencement agreement of the parties or may require determination by the court on the basis of evidence, including a consideration of markets, market conditions and expert testimony.

32. The *Insolvency Guide* discusses the timing of valuation and different valuation mechanisms (see *Insolvency Guide*, part two, chap. II, paras. 66-68).

(c) Use and disposal of encumbered assets

33. Secured creditors will have an interest in the manner in which encumbered assets are treated following commencement of insolvency proceedings and, in particular, the use and disposal of those assets.

34. Where the insolvency estate includes the debtor's rights in encumbered assets, treatment of those assets will depend on the provisions of the insolvency law with respect, for example, to application of the stay, further encumbrance of those assets, use of the assets during the course of the insolvency proceedings, sale or disposal of assets, relinquishment of assets and sale of encumbered assets free and clear of any security rights. Some insolvency laws, for example, provide that only the insolvency representative may dispose of encumbered assets in both liquidation and reorganization proceedings. Other laws provide that the insolvency representative's ability to dispose of encumbered assets in liquidation proceedings is time-limited and, once the relevant time period expires, the secured creditor may exercise its rights.

35. The *Insolvency Guide* discusses the conditions under which encumbered assets may be sold free of security rights (for example, the condition that the security right in an asset extends to the proceeds of the sale of the asset) and the protections to be afforded to secured creditors whose encumbered assets are so sold, including the need to notify secured creditors about any proposed sale or other disposal of

encumbered assets and to give them an opportunity to object (see *Insolvency Guide*, part two, chap. II, paras. 74-89).

6. Post-commencement finance

36. In both liquidation and reorganization proceedings, an insolvency representative may require access to funds to continue to operate the business. The estate may have insufficient liquid assets to fund anticipated expenses, in the form of cash or other assets that will be converted to cash (such as anticipated proceeds of receivables) and that are not subject to pre-existing security rights effective against third parties. Where there are insufficient unencumbered liquid assets or anticipated cash flow, the insolvency representative must seek financing from third parties. Often, these parties are the same lenders that extended credit to the debtor prior to the commencement of insolvency proceedings, and typically they will only be willing to extend the necessary credit if they receive appropriate assurance (either in the form of a priority claim on, or priority security rights in, the assets of the estate) that they will be repaid.

37. In any of these financing arrangements (referred to collectively as "post-commencement finance"), it is essential that the rights of pre-commencement secured creditors in the economic value of the encumbered assets be appropriately protected against diminution (provided that the security right was effective against third parties prior to commencement or after commencement but within a grace period). While some countries permit, in limited circumstances, the creation of a security right to secure post-commencement finance that ranks ahead of a pre-existing security right, the creation of such a security right (sometimes referred to as a "priming lien") should be permitted only where certain conditions are met, including that the rights of pre-commencement secured creditors in the economic value of the encumbered assets are protected against diminution. Post-commencement finance is addressed in some detail in part two, chap. II, paras. 94-107 of the *Insolvency Guide*.

7. Treatment of contracts

(a) Automatic termination or acceleration clauses

38. Parties to security agreements have an interest in the treatment in insolvency of clauses that define events of default giving rise to automatic termination or acceleration of payments under the agreement. Although some insolvency laws permit those clauses to be overridden when insolvency proceedings commence, this approach has not yet become a general feature of insolvency laws. The inability to interfere with general principles of contract law in this way, however, may make reorganization impossible where the contract relates, for example, to an asset that is necessary for reorganization or the sale of a business as a going concern.

39. Any negative impact of a policy of overriding these types of clause can be balanced by providing compensation to creditors that can demonstrate they have suffered damage or loss as a result of a contract continuing to be performed after commencement of insolvency proceedings. In addition, an exception to a general override of such clauses for certain types of contract could be included. The insolvency law could provide, for example, that such a clause does not render unenforceable or invalidate a contract clause relieving a creditor from an obligation

to make a loan or otherwise extend credit or other financial accommodations for the benefit of the debtor after the commencement of the insolvency proceedings.

40. However, if the contractual clause in question relates to an obligation of the party not subject to the insolvency proceedings to make additional loans or other financial accommodations to the debtor, the other party should be relieved of that obligation. It would not be equitable to require additional loans to an insolvent party where the prospect of repayment would be greatly diminished. Requiring the extension of credit after commencement of insolvency proceedings would be especially inequitable if, as described in paragraph [20], no additional encumbered assets are being provided after commencement to the secured creditor. The obligation to make additional loans differs from other contractual obligations where the other party can expect or make arrangements for return performance by the debtor or its insolvency representative (see recommendation 178 of this Guide).

(b) Continuation or rejection of contracts

41. Insolvency laws adopt different approaches to continued performance or rejection of contracts. The *Insolvency Guide* considers a number of the issues relating to the treatment of contracts once insolvency proceedings commence, including the procedures for determining whether contracts should continue to be performed or rejected, treatment of contracts where the debtor is in default on commencement of insolvency proceedings, effects of continuing performance or rejection, leases, assignment of contracts, types of contract for which exceptions might be required and post-commencement contracts (see *Insolvency Guide*, part two, chap. II, paras. 108-147). In any case, what is important for a secured creditor is that rejection of a security agreement does not terminate or otherwise impair the secured obligations already incurred or extinguish the security right and that financial contracts and loan commitments are frequently excepted from the scope of insolvency laws governing the treatment of contracts more generally (see *Insolvency Guide*, part two, chap. II, paras. 208-215).

8. Avoidance proceedings

42. As mentioned above, insolvency law recognizes in principle the effectiveness of a security right, which is a matter of secured transactions law. Nevertheless, the security right may be avoidable in insolvency proceedings on the same grounds that any other transaction may be avoided. For example, the transaction may be avoided as a preferential transaction, an undervalued transaction, or as a transaction intended to defeat, hinder or delay creditors from collecting their claims. Otherwise, the debtor could encumber its assets to prefer one creditor to another on the eve of the commencement of insolvency proceedings, or without obtaining corresponding value, to the detriment of other creditors. The *Insolvency Guide* discusses categories of transactions subject to avoidance, the suspect period, conduct of avoidance proceedings and liability of counterparties to avoided transactions (see part two, chap. II, paras. 148-203).

43. Examples of security rights that may be subject to avoidance include a security right created shortly before the commencement of insolvency proceedings to secure a pre-existing debt; a security right with respect to which one or more of the steps required to make it effective as against third parties have been taken after the creation of the security right, and after the expiry of any grace period for doing so

(see recommendation 189, subpara. (b), of this Guide) but within the suspect period; and the acceptance of an encumbered asset in total or partial satisfaction of the secured obligations (see recommendation 148 of this Guide) at a price significantly lower than the asset's actual value.

9. Participation of secured creditors in insolvency proceedings

44. Where encumbered assets are part of the insolvency estate and the rights of secured creditors are affected by insolvency proceedings, secured creditors should have a right to participate in the insolvency proceedings. In some cases, the extent of a secured creditor's right to vote on certain issues may depend upon the amount by which the secured obligation exceeds the value of the encumbered assets. The extent of such participation may be prescribed by an insolvency law and may include voting on issues specified by the insolvency law, such as selection (and removal) of the insolvency representative; approval of a reorganization plan; and sale of assets outside the debtor's ordinary course of business.

45. The *Insolvency Guide* discusses issues of participation of creditors generally and mechanisms that may be used to facilitate that participation (see part two, chap. III, paras. 75-115).

10. Reorganization proceedings

(a) Approval of a reorganization plan

46. Whether or not a secured creditor is entitled to participate in the approval of a reorganization plan will depend upon the manner in which the insolvency law treats secured creditors and, in particular, the extent to which a reorganization plan can modify or impair their security rights. The value of the encumbered asset in relation to the claim will determine whether the creditor participates as a secured, and also as an unsecured, creditor.

47. Where a reorganization plan proposes to impair or modify the rights of secured creditors, they should have the opportunity to vote on approval of that plan. For that purpose, some insolvency laws classify creditors, including secured creditors, according to the nature of their rights and interests. Under some laws, secured creditors vote together as a class separate from unsecured creditors; under others, each secured creditor forms a class of its own. The *Insolvency Guide* discusses reorganization proceedings in some detail (see *Insolvency Guide*, part two, chap. IV, paras. 26-75), including voting by secured creditors (see *Insolvency Guide*, part two, chap. IV, paras. [38]-[44]).

48. Where secured creditors participate in the approval process, there is a question of whether they are bound by the plan even if they vote against it or abstain from voting. Where secured creditors vote in classes, some insolvency laws provide that, to the extent that the requisite majority of the class votes to approve the plan, dissenting members of the class are bound by the plan, subject to certain protections (e.g. they receive at least as much under the plan as they would have received in a liquidation or they are paid in full within a certain period of time with interest at a market rate). Other insolvency laws provide that the court can order that secured creditors are bound by the plan, provided that it is satisfied as to certain conditions (e.g. security rights are adequately protected and the position of the secured creditor will not deteriorate further as a result of the plan). Yet other insolvency laws provide

that the plan cannot be imposed on a secured creditor unless the secured creditor, or the relevant class of secured creditors, consents.

49. There are several examples of ways in which the economic value of security rights may be preserved in a reorganization plan even though the security rights are being impaired or modified by that plan. If a plan provides for a cash payment to a secured creditor in total or partial satisfaction of the secured obligation, the cash payment or, if cash payments are to be made in instalments, the present value of the cash payments should not be less than what the secured creditor would have received in liquidation. In determining such value, consideration should be given to the use of the assets and the purpose of the valuation. The basis of such a valuation may include not only the strict liquidation value, but also the value of the asset as part of the business as a going concern. For example, if the debtor is going to retain possession of and continue to use the asset under the reorganization plan in order to continue to operate the business as a going concern or if the debtor is going to sell the business as a going concern, this value should be determined by reference to the value of the asset as part of the going concern business rather than the value of the asset as a single item separate from the business.

50. If the plan provides for the secured creditor to release its security right in some encumbered assets, provision could also be made for substitute assets of at least equal value to become subject to the secured creditor's security right, unless disposal of the remaining encumbered assets would enable the secured creditor to be paid in full.

(b) Valuation of encumbered assets

51. Recommendations 49, subparagraph (c)(ii), 50, 51, subparagraph (b), 54, subparagraph (a), 58, subparagraph (d), 59, subparagraph (c), and 67, sub-paragraph (c), of the *Insolvency Guide* provide generally for the value of encumbered assets to be protected in insolvency proceedings. Recommendation 152, subparagraph (b), of the *Insolvency Guide* provides that, under a plan confirmed by a court, each creditor, including a secured creditor, should receive at least as much under the plan as the creditor would have received in liquidation. Issues to be considered in determining the value of encumbered assets are discussed in the *Insolvency Guide* (see *Insolvency Guide*, part two, chap. II, paras. 66-69, and para. 31 above).

52. In order to determine the liquidation value of encumbered assets in reorganization proceedings (for the purpose of applying recommendation 152, subpara. (b) of the *Insolvency Guide*), the use of the encumbered assets and the purpose of the valuation should be taken into account. The liquidation value of the assets may be based on their value as part of a going concern (see recommendation 183 of this Guide).

53. For example, if the debtor is going to retain or dispose of the encumbered assets as part of a going concern sale of the debtor's business, the going concern value of the encumbered assets in the hands of the debtor, if higher than the liquidation value of the encumbered assets separate from being used in the going concern, may better represent a truer value of the encumbered assets given the purposes for which the encumbered assets are to be used.

54. The going concern value may also be the value on which the secured creditor relied in advancing credit to the debtor before the commencement of the insolvency proceedings. The secured creditor may have advanced credit based on the encumbered assets being used in the business as a going concern and generating the necessary profits to repay the secured creditor.

11. Expedited reorganization proceedings

55. In recent years, significant attention has been given to the development of expedited reorganization proceedings (i.e. proceedings commenced to give effect to a plan negotiated and agreed to by affected creditors in voluntary restructuring negotiations that took place prior to commencement of insolvency proceedings, where the insolvency law permits the court to expedite the conduct of those proceedings). Voluntary restructuring negotiations undertaken before the commencement of proceedings will generally involve those creditors, including secured creditors, whose participation is required to ensure an effective reorganization or whose rights are to be affected by the reorganization.

56. The substantive requirements for such expedited reorganization proceedings would include substantially the same safeguards and protections as provided in full, court-supervised reorganization proceedings. However, since the reorganization plan has already been negotiated and agreed to by the requisite majority of creditors at the time the expedited proceedings commence, a number of the procedural provisions of an insolvency law relating to full court-supervised proceedings may be modified or need not apply (see *Insolvency Guide*, part two, chap. IV, paras. 87-92).

12. Treatment of secured claims

57. The principal issue with regard to deciding which creditors will be required to submit claims in insolvency proceedings relates to the treatment of secured creditors. Under those insolvency laws which do not include encumbered assets in the insolvency estate and allow secured creditors to freely enforce their security rights against the encumbered assets, secured creditors may be excepted from the requirements to submit a claim, to the extent that their claim will be met from the value of the sale of the encumbered asset (see *Insolvency Guide*, part two, chap. V).

58. Another approach requires secured creditors to submit a claim for the total value of their security rights irrespective of whether any part of the claim is unsecured. That requirement is limited in some laws to the holders of certain types of security right, such as floating charges, bills of sale, or security over chattels. Some insolvency laws also permit secured creditors to surrender their security rights to the insolvency representative and submit a claim for the total value of the secured obligation. The rationale of requiring secured creditors to submit claims is to provide information to the insolvency representative as to the existence of all claims, the amount of the secured obligation and the description of the encumbered assets. Whichever approach is chosen, it is desirable that an insolvency law include clear rules on the treatment of secured creditors for the purposes of submission of claims.

59. Where the amount of the claim cannot be, or has not been, determined at the time when the claim is to be submitted, many insolvency laws allow a claim to be admitted provisionally, subject to giving it a notional value. Determining a value for

such claims raises a number of issues such as the time at which the value is to be determined and whether it must be liquidated (in which case it will need to be considered by a court) or estimated (which might be undertaken by the insolvency representative, the court or some other appointed person). Where a court is required to determine the issue, an associated question relates to the court that will be appropriate (i.e. the insolvency court or some other court) and how any delay in reaching a determination can be addressed in terms of its effect on the conduct of the insolvency proceedings. As to timing of the valuation, many insolvency laws require it to refer to the effective date of commencement of proceedings (see *Insolvency Guide*, part two, chap. V, para. 38).

13. Ranking of secured claims

60. A secured transactions law establishes the priority of security rights as against competing claimants (for the definition of the terms "competing claimant" and "priority", see A/CN.9/631, Introduction, sect. B, Terminology and rules of interpretation), including the debtor's other secured and unsecured creditors, judgement creditors with a right in encumbered assets and buyers of encumbered assets. Many insolvency laws recognize the pre-insolvency priority of security rights and rank secured claims ahead of administration expenses and other claims (e.g. for taxes or wages). However, where the insolvency representative has expended unencumbered resources of the estate in maintaining or preserving the value of the encumbered assets, those expenses may be given a higher ranking even over a secured claim and, accordingly, may have to be paid out of the proceeds from the sale of or other value attributable to the encumbered assets (see recommendation 182 of this Guide).

61. Other insolvency laws rank secured claims after administration costs and other specified (and generally unsecured) claims (e.g. for wages or taxes) or limit the amount with respect to which a secured claim will be given a higher ranking to a fixed percentage of the claim.

62. The provision of higher ranking for certain unsecured claims, which is often based on social policy considerations, has an impact upon the cost and availability of secured credit. The approach of restricting the amount recovered by a secured creditor from the value of the encumbered assets is sometimes taken with respect to a security right in the entirety of a debtor's assets in order to provide some protection to unsecured creditors (often up to a limited amount).

63. A further approach may permit the ranking of post-commencement secured creditors ahead of the rights of secured creditors existing at the time of commencement (see paras. 36 and 37 above), provided the security rights of pre-existing creditors can be protected.

64. It is desirable that situations in which an insolvency law creates special privileges for certain types of claims ranking ahead of security rights (for example, a privilege for payment of tax or other unsecured claims), those privileges be kept to a minimum and clearly stated or referred to in the insolvency law (see recommendation 180 of this Guide). This approach will ensure that the insolvency regime is transparent and predictable as to its impact on creditors and will enable secured creditors to assess more accurately the risks associated with

extending credit. These issues are discussed in more detail in the *Insolvency Guide*, part two, chapter V, paragraphs 51-79.

65. As already mentioned, insolvency law usually respects the pre-commencement priority of a security right (where the security right was made effective against third parties prior to commencement or after commencement but within a grace period), subject to any privileges for other claims that may be introduced by insolvency law. The same applies to priority of security rights established by subordination (i.e. a change of priority of a security right by agreement, by order of a court or even unilaterally; see recommendation 181 of this Guide). However, subordination should not result in a secured creditor being accorded a ranking higher than its ranking, whether as an individual creditor or as a member of a class of secured creditors, under applicable law. This means that, if secured creditors A, B and C rank in priority so that A is first, B is second and C is third, and A subordinates its secured claim to that of C, B does not obtain a ranking higher than A would have had with respect to the amount of A's claim. It also means that a secured creditor obtaining a subordination from a secured creditor within a class cannot obtain a ranking higher than the ranking of the class.

14. Acquisition financing transactions

66. The treatment in insolvency of security rights and other rights that function so as to secure the performance of an obligation is a key concern of a buyer's, lessee's or borrower's creditors. This treatment can sometimes vary considerably depending on how any particular right is characterized. Generally, but not universally, in legal systems that do not treat retention-of-title transactions and financial leases as security devices, a contract of sale with a retention-of-title clause or a financial lease contract is treated in the insolvency of the buyer or lessee under the rules relating to partly performed contracts (or, in other words, as title devices).

(a) Assets subject to an acquisition security right (unitary approach)

67. In States that integrate all forms of acquisition financing rights into their secured transactions law, retention-of-title transactions and financial leases are treated in the debtor's insolvency in the same way as a non-acquisition security right, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law (see recommendation 174, unitary approach, of this Guide). As a result, the provisions of the *Insolvency Guide* applicable to security rights would apply to acquisition security rights (for the definitions of the terms "security right", "acquisition financing right", "retention of title" and "financial lease" and other relevant terms, see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation).

(b) Assets subject to an acquisition financing right (non-unitary approach)

68. The same consequence as noted in paragraph [67] is produced in some States that maintain separately denominated retention-of-title transactions and financial leases but subject them and similar arrangements to the same rules that apply to non-acquisition security rights, with recognition given to any special priority status accorded to the acquisition security right under non-insolvency law (recommendation 174 (alternative A), non-unitary approach, of this Guide).

69. Where an acquisition security right is treated in the same way as an ordinary (non-acquisition) security right, typically the insolvency representative can use, sell or lease the encumbered assets so long as it gives substitute assets to the secured creditor or the value of the secured creditor's right in the property is otherwise protected against diminution. In such situations, any portion of the secured obligations in excess of the value of the secured creditor's right in the property is treated as a general unsecured claim, and in the grantor's reorganization the secured creditor's claim, up to the value of the security right, can be restructured (as is the case with other non-purchase acquisition security rights) with a different maturity, payment schedule, interest rate and the like.

70. Where retention-of-title transactions and financial leases are treated as partly performed contracts (or title devices), the insolvency representative has the right, within a prescribed time period and if willing and able to do so, to perform the contract by (a) paying the outstanding balance of the price and bringing the property into the estate; or (b) continuing to pay the lease payments as they come due. In some cases, the insolvency representative can assign the contract, together with the right to use the property (which in the case of a lease may require the consent of the lessor) to a third party. Alternatively, the insolvency representative can reject the contract, return the property and claim the return of the part of the purchase price paid by the buyer subject to a deduction for depreciation and use prior to the insolvency. In the case of a lease, the insolvency representative can repudiate the lease for the future and return the property to the lessor. However, if the property is critical to the success of the buyer's reorganization, only the first option (performance of the contract as agreed) would in practice be available to the insolvency representative. The need for the insolvency representative to perform the contract as agreed may, for example in cases where the current value of equipment is less than the balance of the purchase price, result in other assets of the insolvency estate being used to satisfy that performance rather than being used to fund other aspects of the reorganization of the grantor (see recommendation 174 (alternative B), non-unitary approach, of this Guide).

71. If retention-of-title and similar arrangements like financial leases are treated as partly performed contracts (or title devices), the retention-of-title seller and the financial lessor will have stronger rights at the expense of other creditors of the insolvency proceedings. The exercise of the stronger rights might result in some reorganizations not being successful, with possible loss of jobs and with other creditors of the insolvency estate not obtaining as much of a recovery on their claims. Thus, a State considering the treatment of retention-of-title, financial leases and the like in insolvency proceedings should consider whether the State's policy of encouraging the manufacture, supply and financing of equipment or inventory through the strengthening of the rights of retention-of-title sellers and financial lessors outweighs or is subordinate to the State's policy favouring reorganization proceedings.

72. In any case, regardless of whether an acquisition financing right is treated in the insolvency proceedings under the rules applicable to security rights or under the rules applicable to contracts and third-party-owned assets, all acquisition financing rights should be subject to the insolvency effects specified in the *Insolvency Guide*. With either type of non-unitary approach, it may be important to note that the *Insolvency Guide* often recommends the same treatment for the holders of security

rights and third-party-owned assets, including those set forth in recommendation 88 of the *Insolvency Guide* (regarding the application of avoidance powers to, among other things, security rights and acquisition financing rights that are not effective against third parties, whether by the filing of a notice in the general security rights registry or otherwise); recommendation 35 (regarding the inclusion of the debtor's rights in encumbered assets and assets subject to acquisition financing rights within assets constituting the insolvency estate); recommendations 39-51 (regarding the application of provisional measures and a stay to encumbered assets and assets subject to acquisition financing rights and relief from the stay); recommendation 52 (regarding use and disposal of assets of the estate, including encumbered assets and the debtor's rights and interests in assets subject to acquisition financing rights); recommendation 54 (regarding the use of third-party-owned assets); and recommendations 69-86 (regarding the treatment of contracts). Recommendation 35, footnote 6, of the *Insolvency Guide*, which was drafted before finalization of this Guide, is understood to apply to all acquisition financing rights determined by reference to relevant applicable law, whether based on ownership or otherwise.

15. Receivables subject to an outright transfer before commencement

73. An outright transfer of a receivable (i.e. a transfer of a receivable not for security) is within the scope of the present Guide (see recommendation 3 of this Guide); a "security right" is defined to include an outright transfer of a receivable (see A/CN.9/631/Add.1, Introduction, sect. B, Terminology and rules of interpretation). In referring to an outright transfer, this Guide does not affect the application of any rule under law other than insolvency law by which a transaction may be re-characterized as a transfer for security even though the parties denominated the transaction as an outright transfer. In the event of such a re-characterization, the transfer would not qualify as an outright transfer for the purposes of this Guide.

74. If a security right in a receivable created by the debtor before the commencement of the debtor's insolvency proceedings is treated, under law other than insolvency law, as an outright transfer of the receivable, insolvency law should treat the outright transfer of the receivable as it would treat a pre-commencement transfer by the debtor of any other asset where the transfer qualifies as an outright transfer under law other than the insolvency law and exclude the asset transferred outright before the commencement of the insolvency proceedings from the insolvency estate of the debtor (see generally *Insolvency Guide*, recommendation 35, subpara. (a)).

75. However, as with the pre-commencement outright transfer by the debtor of any other asset and, indeed, as with any other pre-commencement transaction, the outright transfer of the receivable is nevertheless subject to the avoidance rules of the insolvency law (see *Insolvency Guide*, recommendation 88). For example, the transfer may be avoided, and the receivable may be brought into the insolvency estate, if (a) the transfer was not effective against third parties at the time of commencement of the insolvency proceedings; (b) the transfer could be avoided under the avoidance rules of the insolvency law relating to undervalued transactions; or (c) in the event that the transfer occurred on one date but was not made effective against third parties until a later date outside of any grace period and

during the suspect transfer period, under the avoidance rules of the insolvency law relating to suspect transfers.

76. If the receivable is not in the insolvency estate and is not brought into the estate under the avoidance rules of the insolvency law, then, because the transferee is the owner of the receivable, any stay arising under the insolvency law should generally not apply to the collection of the receivable by the transferee and the insolvency law should generally not apply to the receivable or to the transferee's collection of the receivable. Nevertheless, if, pursuant to a contract in effect at the time of the commencement of the insolvency proceedings, the debtor has been engaged by the transferee to collect the receivable for the benefit of the transferee, any stay under the insolvency law that is applicable with respect to contracts with the debtor generally (and thus applicable to that engagement contract) would, on that basis and notwithstanding the transferee's ownership of the receivable, prevent the transferee from collecting the receivable or otherwise interfering with the engagement contract until the termination of the stay as to the engagement contract or the rejection by the debtor of the engagement contract (see recommendation 175 of this Guide).

B. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/631 includes a consolidated set of the recommendations of the draft legislative guide on secured transactions, the recommendations are not reproduced here. Once the recommendations are finalized, they will be reproduced at the end of each chapter.*]