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Security interests

Draft legislative guide on secured transactions

Note by the Secretariat*

Addendum

Contents

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XIV. Insolvency

A. General remarks

1. Introduction

1. The preceding chapters of the Guide provide commentary and recommendations aimed at assisting States in the development of effective and efficient secured transactions laws. The goal has been to set out a framework for regulating the rights of grantors, secured creditors and third parties whenever grantors seek to encumber assets with a security right. The Guide generally does not address issues related to the basic law of obligations and property, nor does it directly address matters of civil procedure and the regime governing the enforcement of judgements. The Guide leaves these matters to other law. However, there is one field of law, i.e. insolvency law, where as a practical matter the regime of secured transactions deeply interacts with other law and thus needs to be directly addressed in this Guide.

2. Secured transactions laws and insolvency laws have different concerns and objectives, some of which may overlap where the rights 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 business 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 secured obligations owed are not performed, the economic value of the encumbered assets can be realized to satisfy the secured obligations.

3. An insolvency law, on the other hand, is principally concerned with collective business and economic issues. It seeks, among other objectives, to preserve and maximize the value of the debtor's assets for the collective benefit of creditors and to facilitate equitable distribution to creditors. The achievement of these objectives will be assisted by preventing a race among creditors to enforce individually their rights against a common debtor, and 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 in different ways once insolvency proceedings commence.

4. Since reform of one law can impose unforeseen transaction and compliance costs on parties 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 any 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, as recommended throughout the

UNCITRAL Legislative Guide on Insolvency Law (hereinafter referred to as "the *UNCITRAL Insolvency Guide*"), adopted by UNCITRAL on 25 June 2004.[1]

5. The effects of insolvency proceedings on security rights are discussed in detail, as a matter of insolvency law, in the *UNCITRAL Insolvency Guide*. The purpose of the present chapter is to highlight some of the key points of intersection between an insolvency law and a secured transactions law. The chapter discusses, in section A.3, the general principles concerning security rights in insolvency. Section A.4 reviews the law applicable in insolvency, while section A.5 elaborates upon the treatment of encumbered assets. Section A.6 considers post-commencement finance, section A.7, the treatment of contracts, and section A.8, avoidance proceedings. The next three sections deal with the participation of secured creditors in insolvency proceedings (section A.9), reorganization proceedings (section A.10) and expedited reorganization proceedings (section A.11). The last four sections address the treatment of secured claims (section A.12), the ranking of secured claims (section A.13), acquisition finance (section A.14) and receivables subject to an outright transfer before commencement (section A.15).

6. To provide a sufficient discussion of the effects of insolvency proceedings on security rights in this Guide, core recommendations from the *UNCITRAL Insolvency Guide* that relate particularly to security rights are included in this chapter. For a more complete discussion, however, this chapter should be read together with both the commentary and the recommendations of the *UNCITRAL Insolvency Guide*. This chapter also includes discussion of some additional recommendations elaborating on issues discussed in the *UNCITRAL Insolvency Guide*, but not the subject of recommendations in that Guide. The recommendations from the *UNCITRAL Insolvency Guide* are set out in section B.1 of the present chapter, and the additional recommendations are set out in section B.2.

2. Terminology

7. The *UNCITRAL Insolvency Guide* and the present Guide use a number of defined terms (see *UNCITRAL Insolvency Guide*, Introduction, section B, Glossary, and this Guide, Introduction, section B, Terminology). In addition to the recommendations referred to above, section B.1 of this chapter also includes certain definitions from the *UNCITRAL Insolvency Guide* that facilitate understanding of the recommendations of that Guide.

8. Certain terms that are defined in the *UNCITRAL Insolvency Guide* are not redefined in this Guide and thus have the same meaning as in the *UNCITRAL Insolvency Guide*. Other terms, however, have been either slightly reworded or redefined in this Guide and therefore have a different meaning in this chapter, as indicated below.

9. The term "security right" is defined in this Guide. As used in this chapter it is not a synonym for "security interest" as defined in the *UNCITRAL Insolvency*

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[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 *UNCITRAL 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 http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html.

Guide. The term "security interest" 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 (which are outside the scope of this Guide; see recommendation 5) and non-consensual security rights (which are not covered by the definition of "security right" in this Guide; see Introduction, section B, Terminology).

10. Similarly, the term "priority" is used in this chapter as defined in this Guide and not as defined in the *UNCITRAL Insolvency Guide*. The definition of "priority" in the *UNCITRAL 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"; see section B.1 below). 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 Introduction, section B, Terminology). To refer to "priority" in insolvency proceedings, this chapter uses the term "ranking of claims" (see, for example, paras. 59-63 below).

11. 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 the present chapter, "debtor" in this chapter has the meaning given to the term in the *UNCITRAL Insolvency Guide*, that is, a person that meets the requirements for the commencement of insolvency proceedings (see *UNCITRAL Insolvency Guide*, part two, chapter I, paras. 1-11 and recommendation 8).

12. 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 referring to situations where the grantor is the debtor in the insolvency proceedings.

3. General principles concerning security rights in insolvency

13. The *UNCITRAL Insolvency Guide* recognizes in principle the creation, third-party effectiveness, enforceability (see recommendation 4 of the *UNCITRAL Insolvency Guide*) and priority (see recommendation 1 of the *UNCITRAL Insolvency Guide*) of a security right as established under law other than the insolvency law (see recommendations 235 and 236 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. As noted throughout the *UNCITRAL Insolvency Guide*, 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

14. 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 conflict-of-laws rules applying outside of insolvency proceedings would govern these matters, subject to the limitations discussed in sections (a) and (b) below and the application of avoidance provisions of the insolvency law (see recommendation 220 of this Guide). This result is made clear in recommendation 30 of the *UNCITRAL Insolvency Guide*, which provides that the State in which insolvency proceedings are commenced (i.e. the forum State) should apply its conflict-of-laws rules to determine which State's law governs such questions as the creation and third-party effectiveness of a security right existing at the time of the commencement of insolvency proceedings.

(a) Insolvency effects: *lex fori concursus*

15. Once, under the non-insolvency law applicable outside of insolvency proceedings by virtue of the conflict-of-laws rules of the forum State, the creation and third-party effectiveness of a security right are determined, a second issue arises concerning the effect of commencement of insolvency proceedings on security rights. Points that need to be addressed are, for example, 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. 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, including the ranking of claims, administration and conclusion of the proceedings (the "insolvency effects"; see recommendation 31 of the *UNCITRAL Insolvency Guide*).

16. The insolvency law governing the ranking of the security right may change the relative priority that a security right would have under secured transactions law, and establish categories of claims that would receive distributions ahead of a security right in insolvency proceedings. When establishing these categories of claims, reference should be made 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. Irrespective of issues of ranking of rights, a security right might nevertheless be subject to the avoidance provisions of the insolvency law (see recommendation 88 of the *UNCITRAL Insolvency Guide*).

(b) Exceptions to the *lex fori concursus*

17. 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 situs* or *lex rei sitae*) for the insolvency effects on a security right in attachments to the immovable property. The *UNCITRAL Insolvency Guide* addresses these exceptions in more detail (see part two, chapter I, paras. 85-90 of that Guide), 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 *UNCITRAL Insolvency Guide*, recommendation 34 and part two, chapter I, para. 88).

5. Treatment of encumbered assets

18. 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 several matters. Such matters include, 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

19. 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 section B.1 below). So, the *UNCITRAL Insolvency Guide* recommends that the estate 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 and in third-party-owned assets, as well as assets acquired by the debtor or the insolvency representative after commencement of the proceedings and assets recovered through avoidance actions, should also be included in the estate (see *UNCITRAL Insolvency Guide*, recommendation 35).

(i) Encumbered assets

20. 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 in liquidation. The *UNCITRAL 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 (for the definition of the term "assets of the debtor", see section B.1 below; for a discussion of the estate, see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 7-9) and of applying a stay on commencement to certain actions with respect to security rights (see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 36-40, 56, 57 and 59-69 and recommendation 46, as well as paras. 26 and 27 below).

(ii) Assets acquired after commencement of insolvency proceedings

21. The *UNCITRAL Insolvency Guide* (see recommendation 35, subparagraph (b)), provides that an asset acquired by the debtor after the commencement of insolvency proceedings generally is part of the insolvency estate.

22. Accordingly, even though the secured creditor may have a security right in future assets of the debtor, the security right should not extend to assets acquired by the debtor after the commencement of the insolvency proceedings (see also recommendation 232 of this Guide), unless the secured creditor is providing additional funding. If the security right did extend generally to assets 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 assets 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 assets and those assets were to become automatically subject to the secured creditor's security right and used to satisfy the secured obligation.

23. However, if the assets acquired by the debtor after the commencement of the insolvency proceedings consist of proceeds of assets 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 any applicable grace period), the security right should extend to the proceeds (see recommendation 233 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 to the debtor even where there is no prospect of the commencement of the debtor's insolvency proceedings.

24. An example may be helpful in illustrating these points. A secured creditor has an unavoidable security right in the debtor's entire 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.

25. By contrast, 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. 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

26. 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 (see *UNCITRAL Insolvency Guide*, recommendation 1). 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 (see *UNCITRAL Insolvency Guide*, recommendation 46), 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 (see *UNCITRAL Insolvency Guide*, recommendations 39-45). The *UNCITRAL Insolvency Guide* discusses the scope of actions to which a mandatory or provisional stay applies (see *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 30-40); time and duration (including extension) of the stay (see part two, chapter II, paras. 41-53 and 58); and measures to protect the interests of secured creditors (part two, chapter II, paras. 59-69; see also *UNCITRAL Insolvency Guide*, recommendations 39-51).

(i) Scope of the stay

27. A number of States 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, Enforcement of a security right, of this Guide). It also extends to actions to create a security right or to make a security right effective against third parties (see *UNCITRAL Insolvency Guide*, recommendation 46). 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. 31-34 below).

28. 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 recommendations 176 and 189 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

29. In reorganization proceedings, subject to the safeguards discussed below, it is desirable that the stay apply to security rights 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.

30. It is also desirable that the stay apply to security rights in liquidation proceedings, in particular to facilitate sale of the business as a going concern. The *UNCITRAL Insolvency Guide* recommends that the stay should apply for a short period of time (e.g. 30-60 days) that is clearly set forth in the insolvency law, with provision for the court to provide an extension in certain limited circumstances (see *UNCITRAL Insolvency Guide*, recommendation 49).

(iii) Protection of secured creditors

31. An insolvency law should include safeguards to protect secured creditors where the economic value of their security rights is adversely affected by the stay (see *UNCITRAL Insolvency Guide*, recommendation 50). 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 provide 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.

32. The *UNCITRAL Insolvency Guide* recommends that 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 (see *UNCITRAL Insolvency Guide*, recommendation 51). Some insolvency laws also provide that, once relief has been granted and the stay has been lifted with respect to a particular encumbered asset, the asset may be released to the secured creditor. In such an event, the secured creditor would be free to enforce its security right against such asset under applicable law. Any surplus value remaining after payment of the secured obligation would be part of the estate.

33. 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.

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

(c) Use and disposal of encumbered assets

35. Secured creditors will have an ongoing concern with the manner in which encumbered assets are treated following commencement of insolvency proceedings. Treatment of these 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.

36. The *UNCITRAL Insolvency Guide* recommends that the insolvency law should permit encumbered assets to be used and disposed of or further encumbered in the insolvency proceedings. It sets out recommendations about 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 *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 74-89 and recommendations 52-59).

6. Post-commencement finance

37. 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.

38. 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. While some States 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 *UNCITRAL Insolvency Guide* recommends that 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, chapter II, paras. 94-107 and recommendations 63-68, of the *UNCITRAL Insolvency Guide*.

7. Treatment of contracts

(a) Automatic termination or acceleration clauses

39. 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. The *UNCITRAL Insolvency Guide* recommends that such clauses should be unenforceable as against the insolvency representative and the debtor (see *UNCITRAL Insolvency Guide*, recommendation 70).

40. Any negative impact of a policy of overriding these types of clause can be balanced by providing compensation to creditors that can demonstrate that they have suffered damage or loss as a result of a contract continuing to be performed after commencement of insolvency proceedings or providing an exception to a general override of such clauses for certain types of contract. The *UNCITRAL Insolvency Guide* recommends that the contracts excepted from a general override might include financial contracts and that special rules might be required in the case of labour contracts (see *UNCITRAL Insolvency Guide*, recommendations 70 and 71).

41. The insolvency law could also 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. It would not be equitable to require a lender to make loans or other extensions of credit 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 22 above, no additional encumbered assets are being provided after commencement to the secured creditor (see recommendation 234 of this Guide).

(b) Continuation or rejection of contracts

42. Insolvency laws adopt different approaches to continued performance or rejection of contracts. The *UNCITRAL Insolvency Guide* makes a number of recommendations relating to the handling of contracts once insolvency proceedings commence. These include recommendations about the procedures for determining whether contracts should continue to be performed or rejected, the 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 *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 108-147 and recommendations 69-86). 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 *UNCITRAL Insolvency Guide*, part two, chapter II, paras. 208-215 and recommendation 101).

8. Avoidance proceedings

43. As mentioned above, insolvency law should recognize in principle the effectiveness of a security right that is effective as a matter of secured transactions law. Nevertheless, the security right may be avoidable in insolvency proceedings on the same grounds as any other transaction. 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 (see *UNCITRAL Insolvency Guide*, recommendation 87). Thus, were the debtor to 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 transaction may be avoided as a preferential or undervalued transaction. The *UNCITRAL 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, chapter II, paras. 148-203 and recommendations 87-99 of that Guide).

44. 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 recommendations 176 and 189 of this Guide) but within the suspect period; and the acquisition of an encumbered asset by the secured creditor in total or partial satisfaction of the secured obligation (see recommendations 153-156 of this Guide) at a price significantly lower than the asset's actual value.

9. Participation of secured creditors in insolvency proceedings

45. Where encumbered assets are part of the insolvency estate and the rights of secured creditors are affected by insolvency proceedings, secured creditors should be entitled to participate in the insolvency proceedings (see *UNCITRAL Insolvency Guide*, recommendation 126). That participation may take different forms. Under some laws it includes the right to be heard and to appear in the proceedings, while under other laws, it includes the right to vote on certain specified matters, such as selection (and removal) of the insolvency representative and approval of a reorganization plan, to provide advice to the insolvency representative as requested or on matters specified in the insolvency law, and other functions and duties as determined by the insolvency law, the courts or the insolvency representative. In some cases, the extent of a secured creditor's right to vote on certain issues may depend upon whether the secured obligation exceeds the value of the encumbered assets; if the secured creditor is under-secured, it might participate as an unsecured creditor to the extent that its obligation is not satisfied from the encumbered asset.

46. The *UNCITRAL Insolvency Guide* discusses issues of participation of creditors generally and mechanisms that may be used to facilitate that participation (see part two, chapter III, paras. 75-115 and recommendations 126-137).

10. Reorganization proceedings

(a) Approval of a reorganization plan

47. 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 and the extent to which the value of the encumbered asset will satisfy the secured creditor's claim. Where the value of the encumbered asset is not sufficient to satisfy the secured creditor's claim, the creditor may participate both as a secured and an unsecured creditor.

48. 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 (see *UNCITRAL Insolvency Guide*, recommendation 146). 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 other laws, each secured creditor forms a class of its own.

49. 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). The *UNCITRAL Insolvency Guide* discusses reorganization proceedings in some detail (see *UNCITRAL Insolvency Guide*, part two, chapter IV, paras. 26-75 and recommendations 139-159), including voting by secured creditors (see *UNCITRAL Insolvency Guide*, part two, chapter IV, paras. 34-39 and recommendations 146, 150 and 151).

50. 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.

51. 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

52. Recommendations 49, subparagraph (c)(ii), 50, 51, subparagraph (b), 54, subparagraph (a), 58, subparagraph (d), 59, subparagraph (c), and 67, subparagraph (c), of the *UNCITRAL Insolvency Guide* provide generally for the value of encumbered assets to be protected in insolvency proceedings. Recommendation 152, subparagraph (b), of the *UNCITRAL Insolvency Guide* provides that, under a plan confirmed by a court, all creditors, including secured creditors, should receive at least as much under the plan as they would have received in liquidation. Issues to be considered in determining the value of encumbered assets are discussed in the *UNCITRAL Insolvency Guide* (see part two, chapter II, paras. 66-69, of that Guide and para. 33 above).

53. In order to determine the liquidation value of encumbered assets in reorganization proceedings (for the purpose of applying recommendation 152, subparagraph (b), of the *UNCITRAL Insolvency Guide*), the use of the encumbered assets, the purpose of the valuation and other relevant considerations should be taken into account. The liquidation value of the assets, for example, may be based on their value as part of a going concern (see recommendation 239 of this Guide), which may better represent a more accurate value of the encumbered assets given the purposes for which they are to be used.

11. Expedited reorganization proceedings

54. 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.

55. 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 *UNCITRAL Insolvency Guide*, part two, chapter IV, paras. 87-92 and recommendations 160-168).

12. Treatment of secured claims

56. An important issue for secured creditors is whether they will be required to submit their claims in the insolvency proceedings. Under those insolvency laws that do not include encumbered assets in the insolvency estate and allow secured creditors freely to enforce their security rights against the encumbered assets, secured creditors may be excepted from the requirement to submit a claim. In such cases, they need to file a claim only to the extent that their claim has not been fully met from the value of the sale of the encumbered asset (see *UNCITRAL Insolvency Guide*, part two, chapter V, paras. 1-50 and recommendations 169-184).

57. 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.

58. 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 (see *UNCITRAL Insolvency Guide*, recommendation 178). 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) (see *UNCITRAL Insolvency Guide*, recommendation 179). 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, many insolvency laws require the valuation to refer to the effective date of commencement of proceedings (see *UNCITRAL Insolvency Guide*, part two, chapter V, para. 38 and recommendation 179).

13. Ranking of secured claims

59. 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 Introduction, section B, Terminology, of this Guide), including other secured and unsecured creditors of a debtor, 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 those rights ahead of other claims, such as administration expenses and other claims (e.g. for taxes or wages). Such laws provide that secured claims should be satisfied from the proceeds of sale of the specific encumbered assets or from general funds, depending upon the manner in which the encumbered assets are treated in the insolvency

(see *UNCITRAL Insolvency Guide*, recommendation 188). 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. Accordingly, they may have to be paid out of the proceeds from the sale of or other value attributable to the encumbered assets (see recommendation 238 of this Guide).

60. 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. The higher ranking given to 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).

61. 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. 37 and 38 above), provided the security rights of pre-existing creditors can be protected (see *UNCITRAL Insolvency Guide*, recommendations 66 and 67).

62. It is desirable that situations in which an insolvency law creates special privileges for certain types of claim 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 80 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 *UNCITRAL Insolvency Guide*, part two, chapter V, paragraphs 51-79 and recommendations 185-193.

63. 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 237 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

64. 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 according to how any particular right is characterized in a secured transactions law; the way in which they are treated in the secured transactions law will generally determine how they are treated in insolvency. Accordingly, the *UNCITRAL Insolvency Guide* does not address the issue of how these rights are characterized in secured transactions law and addresses only the treatment of such rights in insolvency, given their characterization by secured transactions law.

65. 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 183, chapter XI, unitary approach to acquisition financing, of this Guide). The same result would occur whenever secured transactions law characterizes a transaction as giving rise to a security right (see recommendation 198, alternative A, chapter XI, non-unitary approach to acquisition financing, of this Guide). Accordingly, the provisions of the *UNCITRAL Insolvency Guide* applicable to security rights would apply to these various acquisition security rights. Where States maintain separately denominated retention-of-title and financial lease transactions, assets subject to these transactions are often not treated by secured transactions law as assets subject to a security right, but rather as assets owned by the seller or the lessor. Accordingly, the provisions of the *UNCITRAL Insolvency Guide* relating to third-party-owned assets would apply to these transactions (see recommendation 198, alternative B, chapter XI, non-unitary approach to acquisition financing, of this Guide).

66. 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 *UNCITRAL Insolvency Guide*. With either alternative of the non-unitary approach (see alternatives A and B of recommendation 198 of this Guide), it may be important to note that the *UNCITRAL Insolvency Guide* often recommends the same treatment for the holders of security rights and third-party-owned assets. This is the case, for example, with respect to recommendation 88 of the *UNCITRAL Insolvency Guide* (regarding the application of avoidance powers to, among other things, security rights); recommendation 35 (regarding the inclusion of the debtor's rights in encumbered assets of the insolvency estate); recommendations 39-51 (regarding the application of provisional measures and a stay to encumbered assets and relief from the stay); recommendation 52 (regarding use and disposal of assets of the estate, including encumbered assets); recommendation 54 (regarding the use of third-party-owned assets); and recommendations 69-86 (regarding the treatment of contracts).

15. Receivables subject to an outright transfer before commencement

67. An outright transfer of a receivable is within the scope of the present Guide although such a transfer is not made for the purpose of securing the performance of an obligation (see recommendations 3 and 164 of this Guide). In any case, irrespective of how it is treated by non-insolvency law, insolvency law treats an outright transfer of a receivable as any other pre-commencement transfer of an asset by the debtor (see generally *UNCITRAL Insolvency Guide*, recommendation 35, subparagraph (a)).

B. Recommendations

[*Note to the Commission: The Commission may wish to note that, as document A/CN.9/637 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*.]