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Draft legislative guide on insolvency law

Note by the Secretariat

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

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

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

Part Two (continued)

III. Treatment of assets on commencement of insolvency proceedings

A. Assets to be affected

1. Introduction

57. [40] Fundamental to the insolvency process is the need to identify, collect, preserve and dispose of assets belonging to the debtor. Many insolvency systems place the assets of the insolvent debtor under a special regime sometimes referred to as the insolvency estate, over which the insolvency representative will have specified powers. This Guide uses the term “estate” in its functional sense to refer to assets owned by the debtor that are controlled by the insolvency representative and are subject to the insolvency proceedings. There are some important differences in the way in which the concept of the insolvency estate is understood in various jurisdictions. In some countries, the insolvency law provides that legal title over the assets is transferred to the designated official. In other countries, the debtor continues to be the legal owner of the assets, but its powers to administer and dispose of the assets are limited (e.g. either the debtor will have no such power, or its powers will be limited to dealing with assets in the ordinary course of business and disposition, including by the creation of security rights, will require the consent of the insolvency representative or the court).

58. [41] Irrespective of the applicable legal tradition, an insolvency law will need to clearly identify the assets that will be subject to the insolvency proceedings (and therefore included within the concept of the “estate” where that term is used) and indicate how they will be affected by those proceedings, including clarifying the relative powers of the various participants with respect to the assets. Identification of assets and their treatment will determine the scope and conduct of the proceedings and, particularly in reorganization, will have a significant bearing on the likely success of those proceedings. A clear statement will ensure transparency and certainty for both creditors and the debtor.

2. Assets of the insolvency estate

(a) General definition of the insolvency estate

59. [43] The estate may be expected to include all assets in which the debtor has an interest, whether or not they are in the possession of the debtor at the time of commencement, including all tangible and intangible assets. Generally, assets acquired after commencement of the insolvency proceedings by either the debtor or the insolvency

representative would also be included. Tangible assets should be readily found on the debtor's balance sheets, such as cash, equipment, inventory, works in progress, bank accounts, accounts receivable and real estate. The assets to be included within the category of intangible assets may be defined differently in different States, depending upon the national law, but may include intellectual property, bills of lading, securities and financial instruments, policies of insurance, contract rights (including those relating to property owned by third parties), and rights of action arising from a tort¹ to the extent of the debtor's interest. In the case of natural persons, the estate may also include assets such as inheritance rights in which the debtor has an interest or to which the debtor is entitled at the commencement of the insolvency or which come into existence during the insolvency proceedings.

(b) Secured assets

60. One question of some importance is whether the insolvency law includes secured assets as part of the insolvency estate. [46] Insolvency laws adopt different approaches to the treatment of assets subject to security interests. Many laws provide that secured assets are included in the insolvency estate, with the commencement of proceedings giving rise to different effects, such as restricting the exercise of security rights held by creditors or third parties (such as by application of a stay and other effects of commencement). Where the secured assets are included in the insolvency estate, they may be subject to certain protections such as those relating to maintaining the value of the secured asset and to specified situations where the secured asset may be separated from the estate (see for example chapter III.C). Where secured assets are to be included in the estate, an insolvency law should make it clear that such an inclusion will not deprive secured creditors of their property rights in the secured assets, even if it does operate to limit the exercise of those rights.

61. [46] Other insolvency laws provide that the security right is unaffected by the insolvency and secured creditors may proceed to enforce their legal and contractual rights. There are examples of laws which provide that even where secured assets are unaffected by the insolvency, the debtor, with the insolvency representative's consent, can ask the court to prevent enforcement where the asset is necessary for the business to continue operating. [47] Exclusion of secured assets may have the advantage of generally enhancing the availability of credit because secured creditors would be reassured that their interests would not be adversely affected by the commencement of insolvency proceedings. However, this general advantage to an economy may need to be weighed against other advantages to be derived in specific insolvency cases, particularly in reorganization and where the business is to be sold as a going concern in liquidation, from having all assets of the debtor available to the insolvency proceedings from the time of commencement. Restricting the exercise of rights by secured creditors may assist not only in ensuring equal treatment of creditors, but may be crucial to the proceedings where the secured asset is essential to the business. For example, where manufacturing equipment or a leased factory building is central to the debtor's business operations, reorganization or sale of the business as a going concern cannot take place unless the equipment and the lease can be retained for the proceedings.

¹ Some jurisdictions exclude torts of a personal nature such as defamation, injury to credit or reputation, where the debtor remains personally entitled to sue and to retain what is recovered on the basis that the incentive to vindicate wrongdoing otherwise would be diminished. [*What is the position regarding personal bodily injury?*]

62. Insolvency laws may provide secured creditors with different options for dealing with their security. These may include, for example, realizing the security where the insolvency law permits this to be done, with the creditor submitting a claim as an unsecured creditor for any shortfall if the amount realized is less than the amount of the claim (where the amount realized is in excess of the claim, the secured creditor will have to account to the insolvency representative for the surplus); having the property valued and submitting a claim as an unsecured creditor for the balance; and surrendering the secured asset to the insolvency representative subject to payment for its value.

(c) Joint assets

63. Where the debtor is an individual and personal property is owned jointly by the debtor and the debtor's spouse insolvency laws adopt different approaches to the treatment of these assets. One approach is to completely exclude the property from the estate. Another approach provides that where the proceedings are opened against the assets of one spouse, the part of the mutual assets belonging to that spouse can become part of the insolvency estate if, under the general law, they can be divided for purposes of execution (where division of the assets will be conducted outside of the insolvency law and proceedings).

(d) Third party owned assets

64. [48] Complex issues may arise in determining whether an asset is owned by the debtor or by another party, and whether assets of a third party that are in the possession of the debtor, subject to use, lease or licensing arrangements at the time of commencement should be included in the assets of the estate. Some insolvency laws treat those assets as subject to the estate. In other cases the estate will generally include, as indicated above in the general definition of the estate, any rights that the debtor might have in respect of the third party owned assets. [48] There will be cases where the third party owned assets, like secured assets, may be crucial to the continued operation of the business, whether in reorganization or sale as a going concern in liquidation, and it will be advantageous for the insolvency law to include a mechanism which will permit those assets to remain at the disposal of the insolvency proceedings. This issue is discussed further in chapter III.C.

(e) Time of constitution of the estate

65. [42] The insolvency law should specify the date by reference to which assets will be considered to be part of the estate to provide certainty for the debtor and for creditors. The estate may be expected to include the assets of the debtor as of the date of commencement of the insolvency proceedings as well as assets acquired by the insolvency representative and the debtor after that date, whether in the exercise of avoidance powers (see chapter III.F) or in the normal course of operating the debtor's business.

3. Assets excluded from the insolvency estate

(a) General exclusions

66. The insolvency law may specify the exclusion of certain assets from the estate. Insolvency laws adopt different approaches to this issue. Assets excluded from the estate may include certain assets owned by a third party that are in the possession of the debtor when the proceedings commence, such as trust assets and assets that are in the possession of the debtor subject to an arrangement (whether contractual or otherwise) that

does not involve a transfer of title but rather use of the assets and return to the owner once the purpose for which they were in the possession of the debtor has been fulfilled.² The treatment of assets being used by the debtor pursuant to a lease agreement where the lessor retains legal title may require special attention. In some jurisdictions, assets in which a creditor retains legal title or ownership (for example, retention of title by the secured creditor, or under a lease arrangement) may be separated from the insolvency estate. In other jurisdictions, if the economic terms of the transaction (that does not involve a transfer of the title to the debtor) demonstrate that is a device to finance the acquisition of an asset, although structured as a lease, the arrangement may be treated as a secured lending arrangement and the lessor will be subject to the same treatment as other secured creditors. A transaction will be a financing device where, at the end of the term of the lease, either the debtor can retain the asset for the payment of a nominal sum or the remaining value of the asset is negligible. Under either approach, the asset may be used by the insolvency representative subject to certain conditions as described in chapter III.C.

[Note that the current draft of the UNCITRAL Legislative Guide on Secured Transactions recommends that all such legal devices be grouped with other forms of secured credit arrangements into a general category of “security interests” and be treated similarly in insolvency proceedings, but this approach is yet to be finalised by Working Group VI.]

(b) Foreign assets

67. Whether the debtor’s property outside the country where the proceedings are taking place will become part of the estate raises issues of cross-border insolvency. Some insolvency laws take the approach that there should be a single insolvency procedure, based in the country where the debtor has its head office or place of registration or incorporation (centre of main interests), that will apply to the debtor’s assets wherever situated (the universal approach). Other insolvency laws are based upon the approach of commencing different proceedings in the jurisdictions in which the enterprise has assets or in which different branches or establishments of the debtor are located (the territorial approach). The diversity of approaches creates considerable uncertainty and undermines the effective application of national insolvency laws. The UNCITRAL Model Law on Cross-Border Insolvency establishes a regime for effective co-operation in cross-border insolvency cases through recognition of foreign decisions and access for foreign insolvency representatives to local court proceedings. The regime is intended to be compatible with all legal systems and is discussed in more detail in chapter VIII.

(c) Where the debtor is a natural person

68. [45] In the case of insolvency of a natural person, the insolvency law may provide that the estate should exclude certain assets such as those relating to post-application earnings from the provision of personal services, assets that are necessary for the debtor to earn a living and personal and household assets, such as furniture, household equipment, bedding, clothing and other assets which are necessary to satisfy the basic domestic needs of the debtor and its family. Where an insolvency law provides exclusions in respect of the assets of a natural person, they should be clearly identified and their number limited to the minimum necessary to preserve the personal rights of the debtor and allow the debtor to lead a productive life. In identifying these exclusions, consideration might need to be given to applicable human rights obligations, including international obligations, which are

² Such an arrangement may be known as a bailment, depositum or [...].

intended to protect the debtor and relevant family members and may affect the exclusions that can be made.³

4. Recovered assets

(a) Avoidance proceedings

69. [50] Assets that will be subject to the proceedings will include any assets recovered by the insolvency representative that were improperly transferred or transferred at a time of insolvency with the result that the *pari passu* principle (i.e. that creditors of the same class are treated equally and are paid in proportion to their claim out of the assets of the estate) has been violated. Most legal systems provide a means of setting aside and recovering the value of antecedent transactions that result in preferential treatment to some creditors or were fraudulent in nature or made in an effort to defeat the rights of creditors (see Part two, chapter III.F).

(b) Unauthorized transactions

70. Many insolvency laws adopt measures intended to limit the extent to which a debtor subject to insolvency proceedings can deal with its assets without the authorization of the court or the insolvency representative. These restrictions generally will apply after the application for commencement of proceedings (in those cases where the powers to deal with assets of the estate are given to an interim insolvency representative) and after the commencement of insolvency proceedings. Some insolvency laws treat transactions which result in the unauthorized transfer of assets as invalid and unenforceable as against the insolvency estate, and enable the assets transferred to be reclaimed, except in some cases where the counterparty gave value or can prove that the transaction did not impair creditors' rights. Other insolvency laws achieve the same result by addressing unauthorized contracts in terms of avoidance provisions. Some of these laws specify the types of transactions that can be avoided in such cases, including performance of obligations arising before commencement, payment of pre-application debts, creation of security over assets of the estate and disposal of any right or asset forming part of the estate.

Recommendations

Purpose of legislative provisions

The purpose of provisions relating to assets affected by the commencement of insolvency proceedings is to:

- (a) identify those assets that will constitute the insolvency estate;
- ~~(b) indicate the manner in which rights in those assets will be affected by the commencement of insolvency proceedings;~~
- (b) identify those assets that will specifically be excluded from the insolvency estate;

³ In Europe, for example, the European Convention on Human Rights is relevant.

~~(d) indicate the manner in which assets owned by third parties and assets subject to a security interest will be affected by the commencement of insolvency proceedings.~~

Content of legislative provisions

Assets constituting the insolvency estate

~~(27) [(24)] The insolvency law should identify the assets to be included in the insolvency estate. Those assets might constituting the insolvency estate should include:~~

- ~~(a) assets owned by the debtor, including both tangible and intangible assets,⁴ irrespective of whether they are in the possession of the debtor and whether they are subject to a security interest in favour of a creditor [*determined in accordance with the property and secured transactions law of the State*];~~
- ~~(b) assets acquired after commencement of the insolvency proceedings; and~~
- ~~(c) assets recovered through avoidance and other actions commenced by the insolvency representative, including in respect of unauthorized transactions.~~

~~(28) In the case of an insolvency proceeding where the debtor has its centre of main interests, the insolvency law should specify whether the insolvency estate would include all assets wherever located.~~

Assets that may be excluded —~~natural persons~~

~~(29) [(25)] The insolvency law should specify which assets are to be excluded from the insolvency estate. Where the debtor is a natural person, ~~the insolvency law should specify the assets to be excluded from the insolvency estate, specifically~~ exclusions will include those assets required to preserve the personal rights of the debtor, which may include assets acquired after commencement of the insolvency proceedings. Exclusions generally are not provided for entity debtors.~~

⁴ Intangible assets may be differently defined according to national law, but may include intellectual property, bills of lading, securities and financial instruments, policies of insurance, contract rights (including those relating to property owned by third parties), and rights of action arising from a tort.