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INFORMAL WORKING GROUP ON INSOLVENCY-RELATED ISSUES

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Informal Working Group on Insolvency-related Issues
Comments on the Paper of the Chairman (Doc. 97)

(submitted by the delegation of the United States of America)

1. General Comments.

The United States expresses its thanks to the chair of the Working Group on Insolvency-related Issues for preparing the Paper (Doc. 97) that has been circulated for comment.

The United States believes that the general approach that the Convention currently adopts for insolvency-related issues is appropriate. The United States does not support any basic changes in approach or the inclusion in the text of unnecessary detail.

The Paper appropriately notes that the Cape Town Convention and its Official Commentary should be consulted in connection with the insolvency-related issues under the Convention, because the provisions of Cape Town on matters such as insolvency law served as a basis for the Convention's provisions. The avoidance of inappropriate inconsistencies between the Convention and the Cape Town Convention in respect of insolvency-related matters is an overarching concern. The Convention should build on the pathbreaking results for asset-based financing under Cape Town. Any differences in approach and text should be based solely on differences between the subject matters and contexts of the two conventions—interests in mobile equipment subject to international registration on the one hand and interests in intermediated securities on the other.

One obvious difference between the Convention and Cape Town contexts is the financial and technological infrastructure of modern financial markets in which intermediated securities are dealt with. The transaction speed and volume, interconnectedness, and inherent risks in systems for settlement and closing out transactions differs radically from transactions in high-value mobile equipment. As recent crises have taught, one goal of the Convention should be to permit financial markets to function seamlessly and without interruption on account of the insolvency of market participants. *Ex ante* insolvency assurances in mobile equipment transactions can provide reductions in credit costs and increases in the availability of credit for the parties directly concerned. But insolvency risks in the financial markets can affect a much wider swath of market participants. Insulation from insolvency risk is even *more* important in the context of intermediated securities than that of mobile equipment.

2. Article 17 *[Effectiveness of Rights in Insolvency Proceedings*] and Article 18 *[Effects of Insolvency].*

a. In general. Article 17, not Article 18, provides the baseline principles for the relationship between the Convention and national insolvency laws. Article 17(1) provides that the rights of an account holder and an interest that has become effective under Article 10 are effective in an insolvency proceeding of the relevant intermediary. Article 17(2) then provides that the Convention does not impair an interest in intermediated securities against an insolvency administrator or creditors if the interest is effective under the non-Convention law. Taken together, these provisions reflect the Convention's goal of making interests in intermediated securities effective. Paragraph (2) recognizes as well that it is not a goal of the Convention to render interests ineffective if the interests otherwise are effective. Given this central role of Article 17, the United States does not agree with the statement in paragraph 2 of the Paper that "Article 18 is the principal insolvency-related provision in the draft Convention."[1]

Article 17(1) derives from a similar provision contained in the draft Convention considered at the first meeting of governmental experts in May 2005. During that meeting, the predecessor of Article 18 was added based on Article 30(3) of Cape Town. The substance of current Article 18 was thought to be a necessary limitation of the principle established in the predecessor of Article 17(1). During the fourth meeting of governmental experts in May 2007, at the suggestion of the United States in Doc. 83 and with support in the plenary, Article 17(2) was added to the Convention. This served to conform the Convention's text even further to the Cape Town Convention inasmuch as Article 17(2) derives from Article 30(2) of Cape Town. Article 18, then, limits the general principles of Article 17.

b. Further clarification of Article 17. The insolvency proceedings that most often will test the effectiveness of the rights and interests mentioned in Article 17(1) are not the insolvency proceedings of relevant intermediaries. Such proceedings are relatively rare. But the applicability of Article 17(1) is limited to "any insolvency proceeding in respect of the relevant intermediary or in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 5."

The more significant insolvency proceedings affecting intermediated securities normally will be those of *transferors*, such as sellers, lenders, and debtors granting security interests, or the insolvency proceedings of an account holder—*not* those of relevant intermediaries. Cape Town Article 30(1) recognizes this by protecting registered international interests in the insolvency proceedings of debtors—the persons who hold interests in equipment that is subject to an international interest. For this reason, the United States believes that Article 17(1) should not be limited to relevant intermediary insolvencies. For example, it might be revised to read as follows:

> 1. - The rights of an account holder under Article 7(1), and an interest that has become effective against third parties under Article 10, are effective against the insolvency administrator and creditors in any insolvency proceeding ~~in respect of the relevant intermediary or in respect of any other person responsible for the performance of a function of the relevant intermediary under Article 5~~.[2]

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[1] Surprisingly, the Paper does not even mention Article 17.

[2] Certainly other drafting approaches may be plausible as well. For example, other approaches to limiting the scope of Article 17(1) might be explored that would, nonetheless, provide for its application in the important insolvency proceedings.

Note as well that Article 17(2), based on Cape Town Article 30(2), is not limited to insolvency proceedings of the relevant intermediary.

While eliminating the unfortunate limitation of the scope of Article 17(1) is important, the United States does not believe that it would represent a major change in the expectations and assumptions that have been the basis for discussions of the Convention to date. We believe that the suggested modification is consistent with the underlying assumptions about effectiveness "against third parties" that lie at the core of Articles 9 and 10. Notwithstanding these underlying assumptions, the limitation of the scope of Article 17(1) in the current text raises doubts that an insolvency administrator would be considered a "third part[y]." The clarification we suggest would eliminate such doubts.

c. Scope of Article 18. The Paper raises questions about the scope of Article 18.

First, the Paper draws the negative implication from Article 18 that the Convention affects the whole of insolvency law except for the matters that the article carves out. In the current version of the Convention Article 18 essentially serves to qualify Article 17. The other articles of the Convention (except for those that specifically address the issue of insolvency) do not appear to affect rules under insolvency law or to be inconsistent with or related to either avoidance in insolvency or procedural rules of insolvency—except as those articles relate to the effectiveness of interests in intermediated securities mentioned in Article 17. The tautological point, here, is that if a provision of the Convention by its terms does not affect the substance of insolvency law, then it does not affect insolvency law even in the setting of a broad Convention override.

Second, the Paper questions whether the scope of the Article 18 carve-outs is sufficiently clear. The United States believes that appropriate clarifications, if any are needed, can be made in the explanatory report or the official commentary to the Convention and do not require adjustment of the Convention text. The commentary should make clear that the applicable non-Convention insolvency law, not the Convention, determines whether an avoidance is one "as a preference or as a transfer in fraud of creditors." For example, under United States bankruptcy law the carve-outs would be interpreted broadly to encompass both "undervalues" (as a species of fraudulent transfer) and "automatic" avoidances (as a species of preference). The commentary also should make it clear that defenses to avoidance claims under the applicable insolvency law should be available. The United States believes that the Cape Town Convention should be interpreted in the same manner. For this reason, clarifying changes to the text of the Convention could be understood to imply that Cape Town should be interpreted in a different way—which would be an unfortunate result to say the least.

Third, the Paper asks which bodies of insolvency law are addressed and affected by the Convention. The United States believes that this matter is appropriately addressed by the Article 1 definitions of "insolvency proceeding" and "insolvency administrator." Additional clarifications in the explanatory report or the official commentary to the Convention could address any remaining ambiguities. While these definitions differ from the corresponding definitions in Cape Town,[3] the differences are not material and this also could be made clear in the explanatory report or the official commentary. Again, material deviations from Cape Town in the Convention text would be undesirable as this would suggest that the terms do not have the same meanings in both conventions.

[3] These definitions also are quite similar to, but not identical to, the corresponding definitions in the Hague Securities Convention.

d. General approach. The Paper raises the issue of the approach of Article 18. Article 17 also should be considered in this context. The United States (as mentioned above) favors the existing approach and would not support either a blanket protection for insolvency law or any extension of the carve-outs.

3. Other insolvency-related Articles.

a. Article 23. The United States supports the substance of Article 23 as it currently appears. Article 23 provides a useful loss-sharing formulation for an insolvency proceeding of an intermediary, absent a conflicting rule applicable in such a proceeding.

b. Article 24. The United States supports the substance of Article 24 as it currently appears. It is intended to allow uniform SSS rules to override insolvency law. The goal is to protect the integrity of SSS and to permit wide latitude in structuring systems so as to limit systemic risks.

c. Article 30. The Paper questions whether Article 30, on enforcement of security interests and the operation of close-out netting, should be applied to override various preferential claims under insolvency law. The United States believes that Article 30 should override such preferential claims. Article 30 would enhance the practical value of collateral and provide certainty for close-out netting in the financial markets. It would benefit markets for all intermediated securities, including government securities markets.

d. Article 33. The United States does not agree with the interpretation of the interaction between Articles 18 and 33 as expressed in the Paper. Article 33 protects agreements for the top-up and substitution of collateral from invalidity based on the occurrence before the commencement of an insolvency proceeding. The Paper concludes that Article 33 does not contradict Article 18 and, consequently, that Article 33 provides no protection against avoidance in insolvency proceedings.

While this is not the appropriate setting to debate drafting points, the United States believes that Article 18 defers to Article 33 to the effect that transactions protected by Article 33 are protected from avoidance. This is the intended meaning of the phrase “[s]ubject to . . . Article 33” in the chapeau of Article 18.