INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

DIPLOMATIC CONFERENCE TO ADOPT A CONVENTION ON SUBSTANTIVE RULES REGARDING INTERMEDIATED SECURITIES
Geneva, 1 to 13 September 2008

UNIDROIT 2008
CONF. 11 – Doc. 9
Original: English
April 2008

Informal Working Group on Insolvency-related Issues

Report

(Submitted by the Chairman of the informal Working Group)

1. The Working Group on Insolvency-related Issues was one of the three informal Working Groups established by the Committee of Governmental Experts at its fourth session from 21-25 May 2008 (see Doc. 95, par. 248). This Working Group considered five issues set out in a Paper (Doc. 97) prepared by its Chairman.

2. The *first issue* concerned the meaning of the current wording of Article 18 of the draft Convention (blanket exclusion of national insolvency law). The *second issue* concerned the justification for the approach under the current wording of Article 18. The *third issue* was whether there was scope for an alternative approach in the wording of Article 18 (blanket protection of national insolvency law). The *fourth issue* was whether there was another suggested approach (extension of carve-outs). The *fifth issue* concerned other articles having insolvency-related effects (Articles 24 and 33).

3. In response to the Paper (Doc. 97), four delegations and one observer submitted comments as set out in Doc. 108 (Australia), Doc. 110 (Portugal), Doc. 111 (Denmark), Doc. 113 (United States of America) and Doc. 115 (UNCITRAL).

4. The Chairman of the Working Group would like to share the following findings.

THE FIRST ISSUE – MEANING OF THE CURRENT WORDING OF ARTICLE 18 (BLANKET EXCLUSION OF NATIONAL INSOLVENCY LAW)

5. The Paper noted that Article 18 states that, subject to the contents of certain specific articles, nothing in the Convention affects rules applicable in insolvency proceedings relating to avoidance of transactions (sub-Article 18(a)) or rules of procedure relating to property under the control/supervision of an insolvency administrator (sub-Article 18(b)). The Paper concluded that the Convention *does affect* all other rules of law and all other rules of procedure applicable in insolvency proceedings – the result being that under Article 18, all *insolvency provisions* under national laws are over-ridden/disapplied with the exception of the "carve-outs" set out in Articles 18(a) and 18(b).

6. With the exception of the submission made by the delegation of the United States of America, none of the other submissions appear to take issue with the "blanket exclusion of national insolvency law" interpretation of Article 18. The submission made by the delegation of the United States of America states that it is "Article 17, not Article 18, that provides the baseline principles for the relationship between the Convention and national insolvency laws, and that the current version of Article 18 essentially serves to qualify the general principles of Article 17".[1] Furthermore, "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".[2]

THE SECOND ISSUE - JUSTIFICATION FOR THE APPROACH UNDER THE CURRENT WORDING OF ARTICLE 18

7. The Paper discussed the policy question as to whether the "blanket exclusion of national insolvency law" interpretation of Article 18 was necessary for the delivery of the objectives of the Convention,[3] and whether interests in such securities should be treated any differently on an insolvency from say, rights to any other asset or property that the insolvent entity might have a claim or interest in.

8. The submission made by the delegation of Denmark generally supported the present wording of Article 18. The submission made by the delegation of the United States of America stated that the general approach which the Convention currently adopts is appropriate, and that the financial and technological infrastructure of modern financial markets in which intermediated securities are dealt with requires insulation from insolvency risk (being even more important in the context of intermediated securities than that of mobile equipment as dealt with under the provisions of the Cape Town Convention). The submission made by the delegation of Australia accepted the need for certainty for participants in the intermediated securities market; however, it also recognised that considerations of certainty and predictability of insolvency outcomes for other stakeholders (especially other creditors) need to be considered.

THE THIRD ISSUE – AN ALTERNATIVE APPROACH (BLANKET PROTECTION OF NATIONAL INSOLVENCY LAW)

9. The Paper noted that the "blanket over-ride" of insolvency law effected by the current wording of Article 18, could however be reversed. In particular, it could be re-worded such that, subject to specific articles, nothing in the Convention affects the application of any provision of national insolvency law. To adopt this approach would mean that each provision of the Convention might need to be re-examined from the perspective of whether the substantive result referred to therein is to apply in all cases and irrespective of national insolvency law.

---

[1] The current wording of Articles 17 and 18 do not appear to reflect this interpretation; the delegation of the United States of America suggests a further clarification of the wording of Article 17 (see paragraphs 22 and 23 below) in this context.

[2] If individual provisions of the Convention *either* specifically address the effect of national insolvency law (either to disapply it or be made subject to it) *or* in the alternate, are not relevant to or affect insolvency, then one might argue there is no reason for any "blanket mention" (whether to over-ride or be made subject to) national insolvency law in the form of the existing wording of Article 18. However, uncertainty would appear to arise since several of the provisions of the Convention (e.g. Articles 9 and 10, 13 and 14) whilst not making any express reference to the effect of national insolvency law (either to disapply it or be made subject to it) would surely require an analysis as to their enforceability (i.e. do they work/mean what they say in accordance with their terms?) in the event of insolvency proceedings say, against a transferor of intermediated securities or the grant of an interest by an account holder of an interest in intermediated securities.

[3] For example, to the extent that such objectives concern the *nature* of intermediated securities (definition and identification of the constituent legal rights in respect of intermediated securities, and the procedures for the transfer of such rights) as distinct from facilitating or promoting legal certainty in *dealings* in such securities more generally.

10. The submission made by the delegation of Australia stated that prospective Contracting States need to assess the operation and scope of their insolvency law in arriving at a position in relation to whether a general disapplication of domestic insolvency law is warranted. The submission made by the delegation of Portugal appreciated the suggestion that in order to accurately evaluate the effect of the Convention on each of the State's "general insolvency law", it is necessary to undergo the task of identifying all of the provisions that qualify as such.

THE FOURTH ISSUE – ANOTHER SUGGESTED APPROACH (EXTENSION OF CARVE-OUTS)

11. The Paper noted that standing between the retention of the current wording of Article 18 and its reversal so as to effect a blanket protection for national insolvency law, one might suggest that the wording of the current carve-outs should be clarified so that, for example, they additionally include undervalues, all provisions for avoidance of transactions (as in the context of "zero hour rules") and the ranking of (preferred) categories of claims or expenses.

12. The submission made by the delegation of Denmark suggested that the text of Article 18(a) is amended so it is made clear that Article 18(a) also covers automatic avoidance rules, such as preferences and "undervalue" transactions as described on page 3 of the Paper, but saw no need to include rules on preferential treatment of certain categories of claim as mentioned on page 4 of the Paper.[4] The submission made by the delegation of Portugal favoured clarification of the wording of the carve-outs, although it did not expressly state the nature of those clarifications. The submission made by the delegation of the United States of America stated 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.[5] Furthermore, any clarifying changes to the text of the Convention could be understood to imply that the Cape Town Convention should be interpreted in a different way.

THE FIFTH ISSUE – OTHER ARTICLES HAVING INSOLVENCY-RELATED EFFECTS

13. The Paper noted two specific reservations or caveats from the general rule contained in Article 18 (i.e. from the blanket over-ride of insolvency). In particular, Article 18 refers to the contents of Article 24 [effects of debits, credits etc. and instructions on insolvency of operator or participant in securities settlement system] and Article 33 [top-up or substitution of collateral].

Article 24

14. The Paper noted that as regards EU Member States, the effect of the rules set out in Article 24 is different from that as contained in the EU Settlement Finality Directive, whereby although a "transfer order"[6] may not be revoked from the moment defined by the rules of the system, the binding and enforceable nature (i.e. finality) of the transfer is only effective notwithstanding the impact of insolvency laws to the extent that the transfer order concerned was

[4] Paragraph 7 on page 3 of the Paper, made two statements: first, that it was assumed that the words of Article 18(a) are intended to cover both preferences and undervalues, and secondly, that it was not clear whether automatic avoidance provisions effected during a suspect period are insolvency-related provisions that are within (or outside) the carve-out in Article 18(a). Paragraph 9 on page 4 of the Paper, questioned whether preferential claims should be disapplied in the case of a security/collateral interest over intermediated securities.

[5] The commentary should make clear that the applicable non-Convention insolvency law, not the Convention, determines whether an avoidance measure 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 species of preference). The commentary should also make it clear that defences to avoidance claims under the applicable insolvency law should be available.

[6] I.e. an order or instruction for the making of payments or the transfer of securities/an interest in securities.

entered into the system "*before the moment of opening of ….. insolvency proceedings*".[7] The draft Convention does not however, contain any requirement as to instructions having entered into the system prior to the onset of insolvency proceedings. Furthermore, the Paper noted that the effect of Article 24 appears to be that each Contracting State ratifying/acceding to the Convention is accepting that the rules of a system given effect to in another Contracting State, will be afforded the same level of recognition irrespective of the criteria or the requirements (if any) stipulated by the relevant other Contracting State that has declared the securities settlement system to have that status for the purposes of the Convention.[8]

15. The submissions made by the delegations of Australia and of Denmark suggested that this article should be made subject to further consideration - either on the basis that consultation with relevant stakeholders on this and other insolvency-related articles was needed (Australia), or on the basis that this article concerned issues regulated by EU legislation (Denmark). The submission made by the delegation of Portugal stated that the complete effect of this article (and Article 33) of the Convention cannot be ensured without first addressing the scope of Article 18 generally. The submission made by the delegation of the United States of America supported the substance of Article 24 as it currently appears, on the basis that it is intended to allow uniform securities settlement rules to over-ride insolvency law, the goal being to protect the integrity of securities settlement systems and to permit wide latitude in structuring systems so as to limit systemic risk.

16. The Paper also noted that the reference to "*to the extent permitted by the non-Convention law*" was presumably a reference to the law of the system. Given that this wording limits the impact of the over-ride afforded to the rules of the system notwithstanding the commencement of an insolvency proceeding in respect of the operator of the relevant system or any participant in the relevant system, the reference to the relevant "non-Convention law" might be clarified in the text of (or any explanatory report or official commentary on) Article 24.[9]

Article 33

17. The Paper stated that the effect of Article 33 is that any delivery of top-up or substitution of collateral in order to take account of changes in the value of the collateral by reference to an increase in credit risk (such as by reason of rating agency triggers) or any other circumstance permitted by the non-Convention law, and a right to withdraw collateral securities provided that other collateral securities or other assets of substantially the same value are substituted, shall not be treated as invalid *solely* on the basis of the relevant provision of securities taking place in a prescribed period before, or on the day of but before, the commencement of an insolvency proceeding in respect of the collateral provider. The Paper noted that this was the intended effect of Article 8(3) of the EU Financial Collateral Directive and that the Directive was intended, whilst

[7] Exceptionally, Article 3(1), second indent, of the Settlement Finality Directive also protects orders entered into the system after the moment of the opening of insolvency proceedings, if they are carried out on that same day and if, after the time of settlement, the settlement agent, the central counterparty or the clearing house can prove that they were not aware, nor should have been aware, of the opening of such proceedings.

[8] Contracting States should therefore note that by ratifying/acceding to the Convention, they are recognising the primacy of the rules of such a system as regards irrevocability of instructions and finality of settlement irrespective of what would otherwise be the effect of any rules of insolvency proceedings commenced in relation to a participant in that system where both those insolvency proceedings are commenced in and that participant is incorporated in their jurisdiction.

[9] For example, this would have the effect (assuming that the relevant non-Convention law is indeed the law of the system) that as regards EU Member States, the difference in the wording of the draft Convention beyond that stipulated in the EU Settlement Finality Directive would not be problematic, since the rules of a system designated under the Directive can only have precedence over the "normal" rules of insolvency law as permitted by the Directive (i.e. to the extent that the relevant transfer orders entered the system before the moment of opening of insolvency proceedings). Two observations might be made: first, that the wording in Article 24 might be better "*to the extent permitted by and in accordance with any restrictions imposed under the non-Convention law*", and secondly, it might be made clear that the relevant non-Convention law (at least in this article) includes a reference to its insolvency law.

disapplying *automatic* "zero hour rules", to preserve the effect of insolvency-related provisions on preferences and transactions in fraud of creditors. The Paper further stated that the current wording of Article 18 is consistent with/delivers the same result as the Directive, since Article 33 (no automatic avoidance of top-up/substitution) does not in fact affect/contradict the operation of Article 18, which expressly preserves the effect of all provisions of insolvency law relating to preferences and transactions in fraud of creditors.[10] Furthermore, the Paper stated that the "alternative approach" for the wording of Article 18 (i.e. the scope of the "blanket over-ride" of insolvency law being reversed so as to produce a blanket *preservation* of insolvency law) will also be consistent with/deliver the same result as the Directive on the basis that the "subject to Article 33" wording would indeed carve-out "zero hour rules" from the generality of the preservation of insolvency law effected by the amended words of Article 18. However, any clarification of the wording of the carve-outs would however, need careful consideration so as to ensure that the "subject to Article 33" wording (i.e. the over-riding effect of Article 33) was indeed preserved.

18. The submission made by the delegation of Australia stated that this article and other insolvency-related articles should be considered further in consultation with relevant stakeholders in terms of coming to a policy position on whether the over-ride/disapplication proposals in the draft articles are warranted. The submission made by the delegation of Portugal agreed that the complete effect of Article 33 of the Convention cannot be ensured without first addressing the scope of Article 18 generally. However, the submission made by the delegation of the United States of America does not agree with the interpretation of the interaction between Articles 18 and 33 as expressed in the Paper; in their analysis, Article 33 protects agreements for the top-up and substitution of collateral from invalidity based on the commencement of an insolvency proceeding.[11]

19. It would seem that these differences of interpretation on the scope of the carve-outs in Article 18, and the substantive content/intent behind Article 33, support the conclusion in the Paper that the wording of Article 33 cannot be clarified without first addressing the meaning/scope of Article 18 generally.

OTHER INSOLVENCY-RELATED ISSUES NOT ADDRESSED IN THE PAPER

Article 30 – enforcement and preferential creditors

20. The submission made by the delegation of the United States of America mentions that in Article 30 (re the context of the enforcement of security interests and the operation of close-out netting), there should be an over-ride so as to disapply various preferential claims which would otherwise exist/be payable in priority under insolvency law. The United States believes that this would therefore enhance the practical value of collateral and provide certainty for close-out netting in the financial markets.

21. The Paper raised the fact that Article 30 was not expressly referred to in Article 18, and therefore presumably was within the general over-ride of insolvency law (subject to the meaning of the carve-outs). Obviously, to the extent that the interpretation of the carve-outs is clarified (whether by express wording in the text of the body of the Convention or in the Official Commentary) then this issue will be clarified. However, there is no guidance on this matter in the current text and it would therefore appear to be an open policy question as to whether preferential claims should be thus disapplied.

[10] See the discussion in footnote 31 on page 8 of the Paper.

[11] This would seem to encompass *all provisions* of insolvency law whether triggered/based on automatic avoidance or otherwise. Such a conclusion would be consistent with the analysis under United States bankruptcy law that the carve-outs in Article 18 presently covers both "undervalues" (as a species of fraudulent transfer) *and* "automatic" avoidances (as a species of preference).

Article 17 - further clarification of effectiveness of rights in insolvency proceedings

22. The submission made by the delegation by the United States of America states that 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 against the insolvency administrator and creditors in any insolvency proceeding of the relevant intermediary. Furthermore, Article 17(2) provides that nothing in the Convention impairs the effectiveness of an interest in intermediated securities against the insolvency administrator and creditors in any insolvency proceeding if the interest is effective under non-Convention law. When taken together, these provisions reflect the Convention's goal in making interests in intermediated securities effective.

23. The reference in the current wording of Article 17(1) is to the insolvency administrator and creditors in any insolvency proceeding *in respect of the relevant intermediary*. The submission made by the delegation of the United States proposes a "further clarification of Article 17" on the basis that the insolvency proceedings which most often will test the effectiveness of the rights and interests mentioned in Article 17(1) "are not the insolvency proceedings of relevant intermediaries", which proceedings are relatively rare, but those of transferors, such as sellers, lenders and debtors granting security interests or the insolvency proceeding of an account holder. Article 17(1) should not therefore be limited to relevant intermediary insolvencies, but should be widened[12] to any insolvency administrator and creditor *in any insolvency proceeding*. Whilst recognising that "eliminating the unfortunate limitation of the scope of Article 17(1) is important" it does not believe that it would "represent a major change in the expectation of assumptions that had been the basis for the discussions of the Convention to date".

24. One might however, argue that Article 17 was only ever intended to address the most important/fundamental principle of the integrity of the intermediated holding system; namely, that the rights of an account holder are to be protected against the *insolvency of the relevant intermediary* (i.e. those words are not unfortunate expressions of limitation but perfectly correct in their context). To now delete the references concerning insolvency proceedings in respect of the intermediary would however, effect a reversal of the current (at least optical) meaning and consequences of Article 17, which should only be contemplated as part of an analysis of the effects of insolvency generally on the individual provisions of the Convention.

UNCITRAL COMMENTS

25. In relation to Article 24, UNCITRAL has commented whether "to the extent permitted by the non-Convention law", includes its insolvency law.

26. In relation to Article 18 and Article 30, UNCITRAL has commented that as Article 18 preserves rules relating to the enforcement/application of stays on proceedings,[13] then it would appear Article 30 [Enforcement] would be subject to the operation of a stay triggered by the commencement of insolvency proceedings (which would surely contradict the purpose of Article 30). Therefore, the words "Subject to Article 30" ought to be included in Article 18, so as to ensure that Article 30 is carved-out from the operation of Article 18.

[12] By deleting the words "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".
[13] I.e. the "rules of procedure relating to the enforcement of rights" referred to in Article 18(b).

CONCLUSIONS

27. The Paper and the submissions received from the various delegations show that there are indeed different approaches regarding the effect of insolvency proceedings on the operative provisions of the Convention, and that further thought ought to be given to the contents of Article 18 (and the scope of the carve-outs, and what is intended when Article 18 is said to be expressly "subject" to the provisions of another article). However, the Informal Working Group cannot of itself draw any "conclusions" as to which particular approach is to be preferred, since that reflects policy choices by Contracting States on the impact of the Convention on their domestic insolvency laws, and the extent to which they believe this is a necessary or desirable element for the achievement of the objectives of the Convention.

- END -