



**DIPLOMATIC CONFERENCE TO ADOPT A
CONVENTION ON SUBSTANTIVE RULES
REGARDING INTERMEDIATED SECURITIES
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MEMORANDUM

**regarding suggestions for revision of the text of the draft Convention relating to
insolvency provisions**

(submitted by the Editors of the draft Official Commentary)

- *This document replaces § 2 relating to Articles 7, 14 and 21
in Document CONF. 11/2 – Doc. 6 Corr. (pp. 1 – 4) –*

Introductory Comment

In this memorandum we suggest some changes to the insolvency-related provisions of the Convention that we previously included in our initial proposal. See CONF. 11/2 – Doc. 6 Corr. These suggestions arose from our discussions with the Secretary General of UNIDROIT and we are indebted to him for his very helpful and constructive advice. The proposed text is marked to reflect changes from our earlier version.

We noted in our initial proposal the difficulties that we encountered in the course of writing the draft Official Commentary with respect to Articles 7, 14 and 21. We do not repeat in full that explanation here. We noted that Article 7 simply states that the Convention does not encroach on the law applicable in an insolvency proceeding “unless otherwise provided.” But we also noted some problematic interpretative issues. We also explained that if Articles 14 and 21 were modified to address the substance in a satisfactory manner, then Article 7 would become unnecessary. Consequently, both our initial proposal and the suggestions set forth below each would eliminate Article 7, would replace Articles 14 and 21 with Article X, and would include a new declaration mechanism provided in Article Y.

With one exception these suggestions do not involve any changes in substance from our earlier proposals. Rather, our goal and the goal of the Secretariat has been to improve the presentation, clarity, and structure of the drafting.

The change in substance relates to the relationship between Article Y and Article 19(5). It became apparent to us that our earlier proposal left a substantial ambiguity as to which priorities would be subject to Article Y’s declaration mechanism and which would be subject to Article 19(5)’s deferral to the non-Convention law (which applies without the need for a declaration). The following draft resolves this ambiguity by making it clear that priority rules relating to non-consensual security interests are subject to the Article Y declaration mechanism in the context of an insolvency proceeding. Outside of an insolvency proceeding, such rules would apply under Article 19(5).

Our suggestions for revisions to Articles X and Y that follow are followed by Explanatory Notes that may form the basis for preliminary drafts of Official Commentary with respect to those Articles.

Article 1
Definitions

~~(q) — “insolvency power” means a privilege, priority or power of avoidance applicable in an insolvency proceeding, other than the rules of law described in Article 21(3)(a), under the law of a Contracting State which has made a declaration under Article Y.~~

Article X (merged Articles 14 and 21)
Effectiveness in insolvency proceedings

1. ~~Subject to paragraphs 2 and 3 and Article Y, rights~~ **Rights** and interests that become effective against third parties under Article 11 or Article 12 are effective against the insolvency administrator and creditors in any insolvency proceeding.
2. This Article does not apply to interests granted under Article 12 by an account holder to the relevant intermediary or any other person responsible for the performance of a function of the relevant intermediary under Article 6 in any insolvency proceeding of such intermediary or such person.
3. This Article does not affect:
 - (a) any rules of law applicable in the insolvency proceeding relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors; or
 - (b) any rules of procedure relating to the enforcement of rights to property which is under the control or supervision of the insolvency administrator.
4. Nothing in this Article impairs the effectiveness of an interest in intermediated securities against the insolvency administrator and creditors in any insolvency proceeding, where that interest has become effective by any method referred to in Article 13.

Explanatory Notes

X-1. Article X deals with Articles 11 and 12 interests in intermediated securities in any insolvency proceeding. Paragraph 1 provides the baseline rule: these interests are effective against the insolvency administrator and creditors. Article X(1) makes explicit what is implicit under Articles 11 and 12, each of which provides that these interests are “effective against third parties.” However, Article X(1) further provides that it is subject to paragraphs 2 and 3 and Article Y, each of which is discussed below.

X-2. Article X(2) provides that Article X does not apply in the case of an account holder that has granted an interest under Article 12 to its own intermediary (such as a secured “margin loan”) or to a “person responsible” under Article 6. In this situation, the account holder has voluntarily granted an interest that should be effective against the account holder and in favour of the intermediary (or “person responsible”). Accordingly, in the intermediary’s insolvency proceeding the account holder’s rights under Article Y(1) *would* be subject to the intermediary’s interest under Article 12, but *only* to the extent of that interest.

X-3. Article X(3) provides that the effectiveness of Convention interests in insolvency proceedings is subject to procedural rules and certain avoidance powers. Article X(3) was inspired by Article 30(3) of the Cape Town Convention. Sub-paragraph (a) exempts from the protection of Article X(1) rules of law relating to the avoidance of a transaction as a preference or a transfer in fraud of creditors. Sub-paragraph (b) preserves procedural rules relating to the enforcement of rights to property, such as a security interest, when that property is under the control or supervision of an insolvency administrator. It follows that these issues are governed by non-Convention law or other law applicable in the insolvency proceedings.

X-4. Article X(4) provides another important protection for interests made effective under methods provided by the non-Convention law and recognised pursuant to Article 13. It provides that nothing in Article X impairs the effectiveness of Article 13 interests in an insolvency proceeding. Stated otherwise, the Article X does not render ineffective in an insolvency proceeding Article 13 interests that are otherwise effective in the proceeding. Article X(4) was inspired by Article 30(2) of the Cape Town Convention.¹

Article Y

~~*Insolvency powers*~~

Special declarations in respect of insolvency proceedings

1. In respect of any insolvency proceeding other than that of the relevant intermediary, a Contracting State may at any time declare, generally or specifically:

(a) priorities or privileges which under the law of that State apply in insolvency proceedings and (i) which shall have priority in relation to an interest that has become effective against third parties under Article 11 or Article 12 or (ii) to which such an interest is subject;

(b) rules of the law of that State other than the rules referred to in Article X(3) (i) which shall apply in insolvency proceedings to interests that have become effective against third parties under Article 11 or Article 12 and (ii) which permit transactions for the transfer of assets or the undertaking of obligations prior to insolvency proceedings to be cancelled or otherwise rendered ineffective and any assets transferred, or their value, to be recovered in the collective interest of creditors.

2. The priorities or privileges declared under paragraph 1(a) may include non-consensual security interests mentioned in Article 19(5).

~~1. A Contracting State may at any time declare, generally or specifically, those categories of insolvency powers which under that State's law (i) shall have priority over an interest that has become effective against third parties under Article 11, Article 12, or both or (ii) to which such an interest is subject.~~

3.2. A declaration made under the preceding paragraph 1(a) or 1(b) may be expressed to cover categories of priorities or privileges that are created after the deposit of that declaration.

4. An interest that has become effective against third parties under Article 11 or Article 12 is not affected by a declaration made after the interest became effective.

¹ Paragraphs X-2 to X-4 of the Explanatory Notes do copy paragraphs 21-7- to 21-9 of the draft Official Commentary relating to Article 21 (cf. CONF. 11/2 – Doc. 5).

5. Notwithstanding the preceding paragraph, a Contracting State may declare, at the time of ratification, acceptance, approval of, or accession to the Convention, that a declaration made at that time pursuant to this Article shall also apply to an interest that became effective under Article 11 or 12 prior to the date of such ratification, acceptance, approval or accession.

~~3. — This Article applies only in an insolvency proceeding but does not apply in an insolvency proceeding of the relevant intermediary.~~

~~4. — Subject to Article 19(5), an insolvency power has priority over an interest that has become effective against third parties under Article 11 or Article 12 and such an interest is subject to an insolvency power only if the insolvency power is of a category covered by a declaration made prior to the effectiveness of such interest.~~

~~5. — Notwithstanding the preceding paragraph, a Contracting State may, at the time of ratification, acceptance, approval of, or accession to the Convention, declare that an insolvency power of a category covered by a declaration made under paragraph 1 shall have priority over an interest that became effective under Article 11 or 12 prior to the date of such ratification, acceptance, approval or accession and that such an interest is subject to the insolvency power.~~

Explanatory Notes

Y-1. Article Y permits a Contracting State to declare additional limitations on the effectiveness of Article 11 and 12 interests in insolvency proceedings. Through the Article Y declaration mechanism a Contracting State may preserve, vis-à-vis Article 11 and 12 interests, priorities, privileges, and avoidance powers under that State's laws which apply in insolvency proceedings.

Y-2. The Article Y declaration mechanism does *not* apply with respect to an insolvency proceeding of the relevant intermediary. The intention is to avoid any substantive change as to the effectiveness of the interests of account holders under Article 11, or of the interests of those whose interests acquired under Article 12 derive from account holders' interests, in the relevant intermediary's insolvency proceeding. Thus, the proposed treatment of those interests under Article X is fully consistent with the treatment afforded under current Article 21.

Y-3. Article Y(1)(a) allows a Contracting State to declare priorities or privileges which are to be afforded priority over Article 11 or 12 interests or to which such interests are to be subject. The provision for these interests to be "subject to" declared priorities or privileges recognizes that the priority or privilege competing with an Article 11 or 12 interest may not involve any property rights or real rights in favour of the beneficiary class. In that circumstance, arguably the competing priority or privilege may not, strictly speaking, involve a "priority" contest. The "subject to" approach is intended to make it clear that such a competing priority or privilege may be declared by a Contracting State.

Y-4. Article Y(1)(b) permits a Contracting State to declare avoidance powers under its laws that will apply to Article 11 or 12 interests in insolvency proceedings. Although sub-paragraph (b) does not use the term "avoidance power" or any similar term, clause (ii) of that sub-paragraph is taken from the definition of "[a]voidance provisions" in the UNCITRAL Legislative Guide on Insolvency Law. The avoidance powers that may be declared under Article Y(1)(b) are in addition to the rules of law and procedure mentioned in Article X(3). The latter rules apply with respect to Article 11 or 12 interests in all insolvency proceedings and apply without the need for a declaration.

Y-5. Article Y(2) provides that priority rules relating to non-consensual security interests may be declared under Article Y(1)(a). Outside of an insolvency proceeding, such priority rules would apply vis-à-vis Article 11 or 12 interests under Article 19(5). In an insolvency proceeding, however, such rules would apply only if covered by a declaration under Article Y(1)(a).

Y-6. As under our initial proposal, this version of Article Y would not compel any Contracting State to adopt an approach that would differ from the substance of current Article 14 – comparable treatment for comparable interests. Any Contracting State that wishes to give Convention interests comparable treatment to other comparable interests could do so by making an appropriate declaration under Article Y. But the Article Y approach has the advantage of eliminating the ambiguity inherent in Article 14 and would provide transparency and public notice. Moreover, it would provide a mechanism for a Contracting State to provide Convention interests with better treatment than “comparable” interests, consistent with recent developments in national, regional, and international law reforms.

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