



**DIPLOMATIC CONFERENCE TO ADOPT A  
CONVENTION ON SUBSTANTIVE RULES  
REGARDING INTERMEDIATED SECURITIES  
Final session**  
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## Comments

*(submitted by UNCITRAL)*

### **Comments on Articles of the draft Convention on substantive rules regarding intermediated securities dealing with insolvency-related matters and on the relationship of the draft Convention with national secured transactions law**

1. UNCITRAL has considered the insolvency-related Articles of the draft Convention on substantive rules regarding intermediated securities, that is, Articles 7, 14, 21, 33, 37 and 37 (the “draft Convention”) contained in CONF. 11/2 - Doc. 4 together with CONF. 11/2 - Docs. 5 and 6, in view of the UNCITRAL Legislative Guide on Insolvency Law (the “UNCITRAL Insolvency Guide”), and the relationship between the draft Convention and national secured transactions law, in view of the UNCITRAL Legislative Guide on Secured Transactions (the “UNCITRAL Secured Transactions Guide”). We would like to offer the following comments.

#### **A. *Insolvency-related Articles***

##### *Article 7 – Effects of Insolvency*

2. Article 7 seems to provide a blanket preservation of the substantive and procedural rules applicable in insolvency proceedings, unless the draft Convention provides otherwise. We read that to mean that insolvency law prevails, unless there is an explicit statement to the contrary in the draft Convention. We note however, that CONF. 11/2 - Doc. 6 suggests that this is not what is desired, since various Articles of the draft Convention are clearly intended to override provisions to the contrary in the insolvency law, without the specific Articles expressly saying so. The example of Articles 11 and 12 is given.

3. CONF. 11/2 - Doc. 6 goes on to say that what is intended is that Article 7 preserve “insolvency specific rules”, such as avoidance and procedural rules. Since “insolvency specific rules” would also include rules dealing with, for example, ranking of claims in insolvency, it seems Article 7 might also preserve these rules. Yet, as mentioned in CONF. 11/2 - Doc. 6, this result may be intended in Article 7 only to the extent that applicable law does not provide otherwise or establish different rules. We note that Article 19 makes no specific reference to the preservation or recognition of those priorities in insolvency.

4. Given the difficulty of drafting a provision that does anything less than establish a blanket preservation or override, preserving for example, only those rules that are “insolvency specific”, we agree with the observation that Article 7 might need some clarification. However, as an alternative to a general rule, it would be preferable, in our view, to adopt the approach of stating clearly in each relevant Article that it is intended to override applicable insolvency law. Unless this result is clear, much of the draft Convention may have no effect in insolvency.

5. Finally, we question the need of drawing a distinction in the draft Convention between substantive and procedural insolvency law, a matter we raised previously in CONF. 11 - Doc. 10, paragraph 3. If the reference is meant to be all-inclusive, the distinction is superfluous. If the reference is meant to exclude some insolvency rules, it is not clear. In any case, it is not for an international convention dealing with security interest matters to draw distinctions that are for national insolvency law.

#### *Article 14 – Effectiveness in insolvency*

6. Article 14 generally addresses the effectiveness, in insolvency, of rights and interests that have become effective against third parties under Articles 11 or 12, that is, by debit, credit or other method, but not under Article 13, that is, under non-Convention law.

#### *Article 14, paragraph 1*

7. The first point made by this paragraph is that rights and interests that are effective under Articles 11 and 12 are recognized as effective against the insolvency representative and creditors in any insolvency proceeding. We assume that the Article is referring to rights and interests that became effective before the commencement of insolvency proceedings, although this is not clear from the terms of Article 14. Of course, the law other than the insolvency law may permit a security interest to be made effective within a certain time period, part of which may fall after commencement, where the insolvency law recognizes that time period and allows the right or interest to be made effective, notwithstanding the commencement of insolvency proceedings (see recommendation 46(b) of the UNCITRAL Legislative Guide on Insolvency Law). In that case, there is no distinction between pre- and post-commencement effectiveness. However, that may not be relevant under Articles 11 and 12 of the draft Convention.

8. The second part of paragraph 1 makes those rights and interests effective to the extent that “comparable interests” are effective in that insolvency proceeding. “Comparable interests” is not a defined term, although some explanation is provided in the draft commentary in CONF. 11/2 - Doc.5. The term “comparable interests” is not one with which we are familiar and is likely, in our view, to cause confusion or uncertainty as to its precise meaning. We also wonder why the first part of the Article refers to “rights and interests” while the second part refers only to comparable “interests”.

9. From a secured transactions law point of view, it is not clear whether the term “interest” is a type of right, in which case it should be clarified or omitted, or has a meaning different from the meaning of the term “right” in which case it should be explained. If, for example, it is intended that the expression “rights and interests” covers ownership interests, security interests and other limited interests other than security interests, use of all these terms or an explanation of the meaning of the term “rights and interests” would be useful. The same would apply if the term “interests” was intended to refer to a part or undivided interest in a right. We note that the UNCITRAL Secured Transactions Guide uses the term “security right” to denote all rights that serve security purposes, including transfers for security purposes, and the terms “part or an undivided interest in a receivable”.

*Article 14, paragraph 2*

10. This paragraph provides that Article 14 does not apply “to the circumstances referred to in Article 21”. We assume that this is intended to mean that it does not apply to the type of insolvency proceedings referred to in Article 21, i.e. “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 6”. If this is correct, we understand that the effect of paragraph 2 is to provide a qualification to the phrase “any insolvency proceeding” in paragraph 1. As a matter of drafting, we would suggest that, for reasons of clarity and ease of understanding and to avoid the need to cross-refer, it might be preferable to either include the words “except an insolvency proceeding referred to in Article 21” in the appropriate place in paragraph 1 of Article 14 or to provide a more specific reference in paragraph 2, for example, “This Article does not apply to the insolvency proceedings of an intermediary referred to in Article 21.” This approach would also have the advantage of more clearly linking the two Articles and clarifying the sphere of application of each.

11. If we understand Article 14 correctly, it states a general principle that covers insolvency proceedings concerning all relevant parties, except the intermediary, which is covered under Article 21. Article 14, however, does not include a saving provision analogous to that contained in Article 21 as it relates to avoidance provisions and procedures concerning enforcement of property rights (the stay). It is therefore potentially unclear as to whether these provisions of applicable insolvency law would apply to Article 14. We assume this issue is not addressed by the reference to comparable interests, as this relates only to the issue of effectiveness. We question, therefore, why carve-outs for avoidance and application of the stay apply only with respect to insolvency proceedings concerning the specific debtor referred to in Article 21 and not insolvency proceedings generally.

12. The UNCITRAL Insolvency Law Guide makes no distinction between insolvency proceedings concerning different types of debtor when addressing the application of avoidance powers or the stay.

13. With respect to avoidance, recommendation 88 provides that notwithstanding that a security interest is effective and enforceable under law other than the insolvency law, it may be subject to the avoidance provisions of insolvency law on the same grounds as other transactions.

14. With respect to the application of the stay, and as noted by us in previous comments (CONF. 11 - Doc. 10), the UNCITRAL Insolvency Guide adopts the approach of applying the stay to security interests, except where they would fall under the financial contracts exception in recommendation 101 (this may to some extent be covered by Article 33(3)). Moreover, as noted above, the insolvency law may recognize provisions of other law concerning time periods for making a security interest effective and allow that to proceed within the time period, even where it overlaps with the commencement of insolvency proceedings.

*Article 21 – Effectiveness in the insolvency of the relevant intermediary*

15. This Article addresses the effectiveness, in the insolvency of the relevant intermediary, of rights and interests effective under Articles 11 and 12. Paragraph 1 repeats the essence of Article 14, without the qualification concerning comparable interests.

16. Paragraph 2 creates an exception with respect to interests granted under Article 12 by an account holder by the credit or debit of securities to the relevant intermediary.

17. Paragraph 3 provides a carve-out for avoidance provisions and provisions concerning the stay, preserving the application of both, notwithstanding paragraph 1. We understand this to mean that, notwithstanding that a right or interest is effective under paragraph 1, it is still subject to the avoidance or stay provisions of the applicable insolvency law.

18. Paragraph 4 repeats the principle in paragraph 1 with respect to the effectiveness of an interest that has become effective under Article 13 under non-Convention law.

#### *Article 33 - Enforcement*

19. Paragraph 3(b) of Article 33 provides that collateral securities may be realised and a close-out netting provision given effect, notwithstanding the commencement or continuation of insolvency proceedings. The intention is presumably that this provision should operate notwithstanding anything to the contrary in the domestic insolvency law, such as the application of the stay to such realisation, prohibition of close-out netting or unenforceability of an *ipso facto* clause. Such an approach is generally consistent with the UNCITRAL Insolvency Guide. However, as noted above with respect to Article 7, this intention needs to be made express in this Article.

#### *Articles 36 and 37 – Top-up or substitution of collateral and certain insolvency provisions disapplied*

20. These Articles, *inter alia*, exempt certain acts from avoidance solely on the basis that they occur within the relevant suspect period under insolvency law. The intention of both Articles is to override contrary provisions of insolvency law; whether the wording in each Article amounts to an express statement such as contemplated by Article 7, however, is not clear. It could be observed that this issue is clearer in the case of Article 37, given its title. Presumably, the acts referred to would still remain subject to avoidance on other grounds, that is, those mentioned in Article 21.

21. This approach is slightly different to (although not inconsistent with) the approach taken by the UNCITRAL Insolvency Law Guide, as the Guide does not recommend the adoption of a particular type of suspect period, that is, one that is either solely time based or incorporating also elements of intent. It does, however, specify that various aspects of financial contracts and netting should be exempt from avoidance provisions. For example, recommendation 104 provides that routine pre-bankruptcy transfers consistent with market practice, such as the putting up or margin for financial contracts and transfers to settle financial contract obligations should be exempt from avoidance. The recommendations also provide for certain exemptions from application of the stay and from those recommendations addressing the unenforceability of *ipso facto* clauses.

#### *Proposals for re-drafting Articles 7, 14 and 21*

22. We have read the draft provisions proposed in CONF.11/2 - Doc. 6. We find Article X to be a clearer statement of the intent of Article 14 and 21, although we note that the wording at the end of 14.3(a) "or control or supervision of the insolvency representative" is unclear.

23. We find the combination of Article 1 and Article Y confusing. It is not clear why different avoidance powers under insolvency law should be treated differently under the Convention; some will still apply by virtue of Article X, while others are subject to the declaration process of Article Y. Moreover the wording of paragraph 1 of Article Y is not especially clear – how would an avoidance power "have priority" over an interest that has become effective under the Convention?

24. We do agree, however, that it needs to be clear how the priorities established under the draft Convention will apply in insolvency. In order to achieve some degree of consistency of approach between Convention Parties, it may be preferable to deal with this issue in Article 19. We note that, in line with the UNCITRAL Insolvency Guide, the UNCITRAL Secured Transactions Guide has dealt with this issue in the following way: the priority of a security right under law other than

insolvency law continues unimpaired in insolvency proceedings, except if another claim is given priority under insolvency law; this rule is subject to the provision of insolvency law dealing with the ranking of secured claims (see recommendations 239 of the UNCITRAL Secured Transactions Guide and 188 of the UNCITRAL Insolvency Guide). Any exceptions to these general principles should be minimal and clearly stated in insolvency law.

25. We note the use of the words “privilege” and “priority”. These appear not to be defined terms. Since they are used differently in different insolvency laws, we suggest the drafting be clarified or definitions be provided to ensure clarity of meaning.

## **B. Relationship with national secured transactions law**

26. We note that the draft Convention refers several matters to national law (secured transactions, insolvency or other law). If national law addresses these matters, there is no problem. In particular, if a State adopts the recommendations of the UNCITRAL Insolvency Guide, all insolvency-related issues should be covered by the national insolvency law. This may not be the case, however, with respect to national secured transactions law, even if a State implements the recommendations of the UNCITRAL Secured Transactions Guide, as this Guide excludes security interests in all types of securities (see recommendation 4, sub-paragraph (c)).

27. We note that, to avoid such gaps with respect to security interests in receivables, the UNCITRAL Secured Transactions Guide deals with receivables, even though receivables are dealt with in the United Nations Convention on the Assignment of Receivables in International Trade. If Unidroit prepares an additional text to address issues not addressed in the draft Convention with respect to intermediated securities, guidance to States would be complete with respect to intermediated securities and references in the draft Convention to national secured transactions law would work well.

28. However, even in this case, no guidance would be provided to States with respect to security interests in non-intermediated or non-traded securities, which are routinely offered as collateral for credit in commercial secured transactions. For this reason, the Commission at its fortieth session made a decision to prepare a text on certain types of securities (non-intermediated, non-traded securities), taking into account the work of other organizations and in particular the work of Unidroit. In this regard, we look forward to coordinating our efforts with yours before we provide suggestions to the Commission as to its future work on security interests early in 2010.

29. Finally, we note that, even though Article 34 provides that, if so provided in the security agreement, the collateral taker has the right to use and dispose of the collateral securities as if it were the owner of them, it is not sufficiently clear whether the draft Convention applies to proceeds of securities that are not securities (for example, receivables arising from the sale of securities). This conclusion appears to be supported by the statement in the draft commentary that the definition of the term “securities” does not cover money deposited to a bank. In this regard, we note that the UNCITRAL Secured Transactions Guide excludes proceeds of assets excluded from the scope of the Guide, even if such proceeds are of a type covered by the Guide but only to the extent that other law establishes a security interest in such proceeds and applies to it (see recommendation 6). It would thus be useful to clarify in the draft Convention that it establishes a security interest in proceeds of securities even if such proceeds are not securities and applies to such a security interest.