

THE NEED FOR AN INTEGRATED APPROACH TO SECURED TRANSACTIONS AND INSOLVENCY LAW REFORMS*

I. Introduction

1. The Office of the General Counsel (OGC) of the Asian Development Bank (ADB) is currently involved in the carrying out of two regional technical assistances to survey the secured transactions and insolvency laws of several of its developing member countries.¹ From 25 to 28 October 1999, the ADB hosted two symposiums at its headquarters in Manila, Philippines, on secured transactions and insolvency law reforms. On 26 October 1999, the participants from both these symposiums (participants from the insolvency symposium are hereinafter referred to as the “Insolvency Team” and participants from the secured transactions symposium are hereinafter referred to as the “Secured Transactions Team”) were brought together for a joint session to discuss various economic and legal issues arising from the intersection of secured transactions and corporate insolvency (hereinafter “Joint Session”).

2. The Joint Session presented a rare opportunity to consider the underlying policies and principles and the consequent goals and aims of secured transactions regimes in conjunction with those of insolvency law regimes. In this regard, participants from both symposiums brought a different focus to the issues involved.² It is doubtful that such a forum has previously been assembled, at least for the purpose of a general consideration of the intersection of the two areas. It is surprising that the two areas have not been considered together more often. Particularly as, in a wider international context, such a need has been increasingly recognized.³

3. While not discussed at the Joint Session, it is worth noting the context in which secured transactions and insolvency regimes operate and influence. Insolvency and secured lending are part of the larger system of commercial law, and as such each occupies its respective area of influence and importance within the wider framework of commercial law. Both are concerned with debtor-creditor relationships, an area that, in turn, is part of a wider

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¹ Respectively, TA No. 5773-REG: Secured Transactions Law Reforms (hereinafter “RETA 5773”), covering Indonesia, India, Pakistan, People's Republic of China, and Thailand; and TA No. 5795-REG: Insolvency Law Reform (hereinafter “RETA 5795”), covering Hong Kong, China; India; Indonesia; Japan; Korea; Malaysia; Pakistan; Philippines; Singapore; Taipei, China; and Thailand. The design and methodology of this regional technical assistance (RETA) is more fully addressed in the following report in this publication. The design and methodology of RETA 5773 will be presented in Vol. II of this publication. The economies covered by both RETA 5773 and 5795 are collectively referred to as the “Economies.”

² The participants included local experts, judges, bankruptcy practitioners, policy makers, scholars, lawyers, bankers and accountants. Also present were delegates from various legal institutes and other multilateral institutions, including the World Bank, the International Monetary Fund, and the Organization for Economic Co-Operation and Development.

³ Both UNCITRAL and UNIDROIT have recognized the importance. UNCITRAL in its work on a draft convention on assignment of receivables in international trade (which includes securitization of receivables) has convened a number of sessions to take the opinions and advice of insolvency law specialists regarding insolvency related aspects of the draft convention. UNIDROIT in its work on a draft convention on international interests (including security interests) in mobile (particularly aircraft) equipment, has convened special working groups comprised of both insolvency and secured transaction experts to consider insolvency related implications. Both of those projects have benefited considerably from the interaction. Additionally, the Group of 22 Report, Report of The Working Group on International Financial Crises, published October 1998, also recognized the importance of adopting an integrated approach to secured transactions and insolvency law reforms.

commercial law system. As such, improved secured transactions and insolvency regimes have an important role to play in the promotion of better corporate governance. Debtor-creditor relationships, particularly those arising from secured transactions, are based on contractual obligations. Any breach of such contractual obligations by a corporation will, normally, signal financial distress and the need for remedial action. Ultimately that may lead to the removal of those responsible for the management of the debtor corporation and/or the redeployment of assets to create more value. For example, some secured transactions regimes give secured creditors the power to interfere or replace management in the event of a breach of the contractual obligations that underlie the secured transaction.

4. Most insolvency law regimes will provide for the possibility of interference with or replacement of management of an insolvent corporation as a means of structuring a reorganization of the corporation and its assets. The prospect of these types of sanctions can produce a powerful incentive on the part of corporate management to take, for example, a responsible attitude toward the incurring of debt; honoring debt contractual obligations; and taking affirmative action in the event of financial distress (by, for example, seeking an informal work out with creditors). Responsible attitudes of that nature may be regarded as consistent with the application of proper standards of corporate governance. On the other hand, if the means to enforce debtor-creditor contractual obligations (either through the application of a debt enforcement regime or an insolvency regime) are weak or inefficient, it is highly likely that the management of a corporation will choose to ignore such governance standards.

5. While secured transactions and insolvency law regimes may have in common desired benefits on corporate governance, both may in case of an insolvent enterprise have different objectives. There is therefore room for considerable potential tension and irreconcilable conflict between the two areas. The differences between them may be expressed in a variety of ways, but the more essential differences may, perhaps, be best stated as follows:

- Each postulates a different approach to debt. Insolvency may be viewed as a system of law that endeavors to deal with debts that cannot be paid as they fall due or cannot be paid in full. Secured transactions may be viewed as a system of law that endeavors to assure that debts will be fully paid even if the business enterprise can no longer be profitably run.
- Each endeavors to uphold different rights. Insolvency is concerned with enhancing or at least maintaining the value of a firm's assets by preventing a destructive race between individual creditors to grab a firm's assets through uncoordinated individual enforcement action, and maintaining rights based on collective treatment of creditors with equal rights. Secured lending is concerned with maintaining creditors' asset-based rights and promoting individual enforcement.
- Each has a different stakeholder constituency. Insolvency is concerned with maximizing the value of the whole of the property of the debtor for the benefit of all creditors. Secured lending is concerned with maximizing the value of the particular secured property of the debtor for the benefit of an individual creditor. If the central aims of one area are pursued without a consideration of those of the other, clash and disharmony is inevitable.

6. With this in mind, Joint Session participants sought to:
- Define those instances when the collective or public interest justified allowing bankruptcy to interfere with the rights of secured creditors;
 - Define the types of interferences that should be permitted; and
 - Propose mechanisms to protect the interests of secured creditors whose rights have been adversely affected by such interference.
7. A challenge presented by the intersection of secured transactions and insolvency laws is to address and resolve the problem presented by competing claims to the property of an insolvent corporate debtor. Or, to put the challenge another way, any insolvency law reform must address the competing claims to an insolvent debtor's property or to the funds realized from that property. At the epicenter of this competition are the claims of those whose rights are derived from secured transactions.
8. In a mature market economy, it may be expected that the great majority of the debt incurred by corporations will be secured transaction debt. Secured lending in such an economy will be based on a highly developed legal framework supported by equally highly developed commercial techniques and practices. In short, secured transaction lending will constitute a major part of the commercial law and practice of such an economy.
9. In some of the Economies, the insolvency law regime is not sufficiently definitive regarding the treatment of secured property interests. The areas of concern include the absence of a clear statement in the insolvency law of the effect of a bankruptcy upon a secured property interest and the absence of a clear statement of the extent to which preferred creditors claims (e.g., tax authority claims) have priority to the proceeds of the sale of secured property over the interests of secured creditors.
10. A basic principle that should be followed in the creation or reform of an insolvency law is that, as far as possible, it should relate to and support well-settled commercial laws and practices. It follows, from that statement of principle, that an insolvency law should endeavor to relate to and support secured transaction lending on the basis of a stable and predictable legal framework.
11. However, it may also be expected that an insolvency law will be subject to the application of other principles and policies to which it must endeavor to also respond. One of these is the more modern economic policy that an insolvency law regime should endeavor to maximize the value of the property of a debtor for the collective benefit of all creditors. Another policy is based on principles of fairness. This policy maintains that transactions involving the property of a debtor that have offended basic principles of commercial and legal fairness or that have unfairly interfered with the principle of equal sharing between creditors should be set aside. Yet another policy is one that requires that particular creditor interests, such as claims of employees of an insolvent debtor or the fiscal claims of the state, should be protected and preferred. The application of that policy may require that the property of a debtor (or the proceeds of the sale of that property) be distributed first in favor of those interests above all others, including secured creditors rights.
12. The "challenge" mentioned above arises when the "property" referred to in relation to the application of those latter policies and principles is the same, or includes, "property" that has been secured as a result of a secured transaction. It is this that creates the potential conflict of interest and disharmony between principles of secured transactions and insolvency laws. The following discussion explores how the interplay of these principles of law may be harmonized.

II. An Examination of the Issues Arising From the Intersection Between Secured Transactions and Insolvency

13. The intersection between secured transactions and insolvency may be examined in a number of different ways. The Joint Session took the approach of considering this by reference to three time periods - pre-insolvency commencement, upon the commencement of a formal insolvency proceeding, and post-insolvency commencement.

14. The first of these embraces the creation of secured property interests and, more specifically, a registration and information system regarding such interests and the enforcement of secured property rights. The second is concerned with the effect of the commencement of a formal insolvency process upon secured property interests. The third is directed at other (and, possibly, continuing) effects on secured property interests after the commencement of a formal insolvency process.

A. Pre-Insolvency Commencement

15. This time period is concerned with the creation of secured property interests; registration and information systems concerning secured property interests; and enforcement of secured property interests. This may, at first, appear to be outside the ambit of the focus and aims of insolvency because it is concerned with the core of a secured transaction legal regime. Nonetheless, much of it is highly relevant to corporate debt and insolvency.

16. The Creation of Secured Property Interests. If secured transactions are to be commercially effective, a legal regime is required that enables secured property interests to be created, identified and recognized. Such a regime would provide for (and, possibly, govern) the consensual creation of such interests by agreement. It might also extend to identifying secured property interests that may arise by operation of law; an area that may be of some importance in common law based jurisdictions.

17. The importance of such a codified legal regime for commercial purposes is that it provides an efficient system by which secured property interests may be identified and recognized. That is obviously important for the commercial community as a whole. But it also has an important practical benefit for insolvency law purposes. Upon the insolvency of a debtor whose property has been secured, the person or institution administering the insolvency is able to recognize such interests more easily and with more certainty than in the absence of codification.

18. There was no disagreement between participants at the Joint Session that the implementation of an efficient system of secured lending produces important economic and social benefits. It was posited at the Joint Session that secured lending supports a sevenfold increase in credit with no additional risk. It was also claimed that as the quality of collateral increases the interest rate decreases up to a factor of fifty percent and the ratio of debt/income rises more than eight-fold. Similarly, as the quality of collateral improves, the loan size dramatically improves, as does the term length.⁴

19. However, participants noted at the Joint Session that secured lending could create a moral hazard. It was pointed out that this was the recent experience in many of the Economies where banks relied primarily on asset-based or name lending rather than on cash-flow analysis. As borne out during the Asian financial crisis, the consequences can be

⁴ See the report of RETA 5773, titled Integrating the Legal Regimes for Secured Transactions and Bankruptcy: Economic Issues (hereinafter "RETA 5773 Report"), at p.10.

dire for lenders when borrowers are unable to repay their debts and the value of the collateral collapses. It was even queried whether the law should penalize reckless lending. Despite the foregoing, it was agreed at the Joint Session that an effective system of secured lending is important, and that an effective secured transactions system acts as an engine of economic growth.

20. It was noted that in most of the Economies secured lending was solely focused on mortgages of land or pledges of shares. In only a few of the Economies had there been much, if any, development of secured lending over movable and other property. This, in part, was because of the absence of a developed secured transactions legal regime. In many of the Economies the secured transactions legal regime was very under-developed; and the range of secured transaction lending was extremely limited. Further, the system of creation and registration of secured property interests was, in some cases, inefficient and uncertain.

21. Moreover, secured lending on mortgages over land and pledges of shares appeared to be accompanied by weak loan assessment and loan monitoring practices of banks and other financiers. This was because loan assessment and subsequent review was concentrated on the value of the land or the shares as security. There was very little evidence of any widespread credit assessment practices that were concerned with the business of a corporate borrower, its income, profitability and cash flow. In those Economies in which secured lending over movable property was more practiced there was a far greater assessment of the ability of the corporate borrower to service the borrowing.

22. Registration and Creation of Secured Property Interests. Issues concerning the validity and enforceability of a secured property interest may, as between the parties to its creation, be determined by reference to the agreement by which, or the circumstances under which, it was created and the relevant law concerning creation. In that respect, a system of registration of such interests may not be of critical importance.

23. However, it is critical to determine whether such a secured property interest will be valid and enforceable against other persons, for example persons who claim security over the same property or a purchaser of the property. That determination may depend on other requirements of a secured transactions law. These might insist that the creation of such an interest be registered or notified on a public register.

24. It appears to be generally recognized that the interests of a commercial community will be better served if the creation of secured property interests is subject to such a registration or notification system. This is usually linked to the concept of "perfection" of a security interest. In jurisdictions that provide for "perfection," a secured property interest will only be valid and subsist against third parties if registration or notification perfects it.

25. Many systems of law provide for such a registration or notification system. Participants at the Joint Session indicated a strong preference for registration systems. These systems can serve a number of important functions that are both directly or indirectly related to insolvency.

26. First, the registration or notification of a security interest can provide important information regarding both the asset worth and the credit worth of an enterprise. It may be regarded as important that persons who deal with an enterprise (for example, existing or prospective creditors) know or, at least, are afforded the opportunity to know if the property of an enterprise has been secured in favor of a lender or credit provider. This assists in the assessment of loan and other credit requests. It may be readily determined if a corporation has created security interests over its property and the terms and effect of those interests. It

may also help to expose or lessen the possibility of a debtor pretending to possess that which is sometimes referred to as “false wealth.”⁵

27. An insolvency regime will function more effectively as a result of the availability of informed credit assessment information. It may result in a lesser number of insolvent corporations or there may be less insolvent corporations that are hopelessly burdened by debt and better candidates for possible rescue or reorganization.

28. Second, a registration system that is used as a means of perfecting and validating security interests provides more certainty of recognition of secured property interests. From an insolvency perspective, it may mean (depending on the policy that is adopted under the secured transactions registration regime) that an unperfected secured property interest will be invalid against the person who administers the liquidation or other insolvency administration of an insolvent corporation. That enables the property to be dealt with free from claims of such interests.

29. Third, if a registration system is used to create or enhance the certainty of a priority system between possible competing security interests in the same property it will make issues of priority between secured creditors more certain and reliable. That, in turn, will assist in the administration of an insolvent corporation. It means that an insolvency administrator can determine the relative order of priority between secured creditors in respect of the same property and can further determine and assess their relative position of power and influence. These are important pragmatic considerations in the context of, for example, the practicalities involved in proposing a plan of reorganization. Account must be taken of secured creditors and the possible continued availability of secured property for the purposes of a reorganization.

30. For the above reasons it may be submitted that a registration and information system in respect of the creation of secured property interests serves an important purpose for an insolvency regime. It contributes to a more certain and predictable debtor-creditor legal regime of which, as mentioned earlier, the insolvency law regime is part.

31. Enforcement of Secured Property Interests. It may be expected that a secured transactions legal regime or some other law will deal with the enforcement rights of secured creditors. This will usually cover such things as the right to enforce a debt obligation by foreclosure and sale of the secured property, the process of enforcement and the ultimate sale of the secured property. It is an area that is of vital importance to secured transactions.

⁵ The phenomenon of “false wealth” arises when an owner of property can pretend or give the appearance that the property is owned outright and is not subject to any secured debt interest. This can occur as a result of an undeveloped or defective secured transactions legal regime, as, for example, if secured property interests cannot or do not have to be registered or notified. The owner can claim that his “wealth” includes the full value of the property without revealing that the property is, in fact, security for a liability and deducting that liability from his “wealth.”

32. Indeed, an efficient enforcement system is a key component of an effective secured transactions system. It also has some considerable indirect importance for an insolvency law regime. Participants at the Joint Session strongly agreed that the efficiency of the enforcement system is a key factor for parties in determining whether to pursue informal or formal workouts. It was agreed that an inefficient system of security enforcement often leads to an ineffective and overburdened corporate rescue system. This is because secured creditors seek to use the corporate rescue system as a means of debt collection.⁶

33. Default by a debtor in relation to a secured debt will often signal that the debtor is in severe financial difficulty. The creditor will normally seek to exercise powers of enforcement in relation to the secured property. If the creditor is constrained or impeded in exercising those powers by weaknesses in the relevant law or by inefficient application of the legal processes that must be followed, a number of consequences may follow. First, the debtor may be encouraged to take every possible advantage of the ineffective legal system to delay and frustrate the enforcement process. Second, the debtor will not be encouraged nor feel compelled to seek relief from its financial predicament under, for example, the reorganization process of the insolvency law. In the meantime, the financial affairs of the debtor may deteriorate. Third, the creditor may be driven to employ other remedies and may, for example, seek to bankrupt or liquidate the debtor under the bankruptcy law.

34. None of these possible consequences are desirable. For insolvency law purposes, a strong and effective secured property enforcement law and process can be a valuable ally to encourage an insolvent corporate debtor to volunteer for reorganization at an early stage. The absence of or weaknesses in such an enforcement regime means that there is no pressure or persuasion on an insolvent debtor to take remedial action to prevent dismemberment of the property of the debtor. It is also not a desirable consequence that a secured creditor seeks to apply an insolvency law as a method of debt enforcement. This puts an unwanted strain on the insolvency law system.

35. An effective and efficient secured property enforcement regime is, therefore, important for insolvency law purposes. It was noted at the Joint Session that many of the Economies lack an effective enforcement regime. Overall, it was acknowledged that the enforcement processes in many of the Economies take too long, are too expensive, and are commercially inefficient.

36. For instance, in many of the Economies (particularly Pakistan, India, Philippines, Thailand and Indonesia) there were considerable problems regarding the enforcement of secured property rights. The reasons for this varied. In most of these Economies, secured property enforcement has to be conducted through the courts.⁷ Court processes and defensive debtors resulted in extensive delay. Also, in some of the Economies, after a court order is obtained that permits foreclosure, the sale and realization of the secured property has to be conducted through a government agency. It is not generally possible for a secured creditor to employ self-help enforcement remedies even if the law provides for it since the

⁶ When a creditor is forced, because of inefficient debt enforcement remedies, to resort to insolvency remedies it will sometimes result in an agreement between the debtor and the creditor and the termination, withdrawal or lapse of the insolvency proceeding. Yet, an insolvency proceeding should not be lightly terminated simply because the debtor and creditor have reached an agreement. An insolvency proceeding is or should be regarded as a "collective" procedure, one that is brought for the benefit of all creditors, whether they know about it or not. Despite that a creditor who brings an insolvency proceeding and the debtor against whom it is brought may have reached some agreement between themselves, the court may have to order an inquiry to determine if there are other creditors and whether they might wish to participate in the insolvency proceedings. This creates cost, delay and it is time consuming for the court. It can mean that the insolvency court becomes, in a de facto sense, a debt collection court, which is far from its proper function and purpose.

⁷ Even where special tribunals have been created (e.g., India), they have not lived up to their promise.

general inefficiency of the law (and order) regime does not provide adequate protection to a creditor who seeks to enforce such self-help remedies (e.g., India and Pakistan).

37. The difficulties associated with enforcement create a situation in which a corporate debtor has no real concern about threats of or actual resort to enforcement proceedings. This not only has a serious impact on secured transaction lending but it also means that one of the most effective debtor-creditor sanctions to apply to an insolvent corporate debtor is absent or ineffective. It also often results in secured creditors using the insolvency law to enforce their individual rights. Consequently, the debtor-creditor commercial system becomes considerably twisted.

38. It is possible that the insistence in many of the Economies upon court and government agency regulation in relation to the enforcement of secured property rights is due to an understandable concern to protect certain classes or categories of borrower, for example consumers, farmers and small business people. It is difficult, however, to understand why it is necessary to apply the same degree of regulation to secured transactions involving corporations.

B. Commencement of Formal Insolvency Proceedings

39. A number of issues arise concerning the immediate effect of the formal commencement of insolvency proceedings on secured transactions and related issues. Three areas are addressed. The first is concerned with recognition of rights over secured property; the second deals with the power to avoid secured transactions, and the third considers the effect on enforcement powers of secured creditors.

40. General Recognition of Secured Property Interests. It is necessary that the law, whether through an insolvency or some other law, clearly state if secured property interests will be recognized upon the commencement of a formal insolvency administration. Without such a statement there will be doubt and uncertainty.

41. The law may thus provide that security interests that do not conform to or comply with the law relating to the creation and registration of a secured property interest shall be invalid and unenforceable in the administration of the debtor. This does two things. First, by creating a sanction in the form of potential invalidity and unenforceability, it reinforces the necessity to conform to and comply with the formalities associated with the creation and perfection of secured property interests. Where the law includes registration of secured interests, this promotes greater transparency with respect to the debtor's assets and avoids the problem of "false wealth" mentioned above. Second, as mentioned previously, it provides for certainty of recognition and continued rights in relation to secured property interests. That is important for commercial predictability.

42. Power to Avoid or Invalidate Secured Property Interests. Although a secured property interest may have been validly created and perfected according to the relevant secured transaction legal regime, it may have been created or procured by means or in circumstances that conflict with insolvency law regime policies and principles.

43. It is common for insolvency law regimes to provide for the invalidation or avoidance of certain types of transactions. This is designed to protect creditors from fraudulent or uncommercial transactions concerning the property of an insolvent debtor, particularly if the transaction has been made between an insolvent debtor and a person closely connected with the debtor. Thus, a transaction that effects a fraud upon creditors (for example, the creation of a security over property to secure a fictitious loan) or otherwise prejudices or disadvantages creditors (for example, the creation of a security over property by way of gift

or in return for no or no sufficient payment or value) may be avoided. Both Teams at the Joint Session were in agreement on this point.

44. An insolvency law may also seek to promote and reinforce the principle of maintaining equality between creditors by providing that a transaction that benefits or advantages one creditor of a particular class over other creditors of the same class may be avoided. For example, an unsecured creditor of a debtor may require payment of the debt. The debtor, who cannot pay, is required to create a security over its property in favor of the unsecured creditor to secure payment of the debt. Thus, the unsecured creditor becomes a secured creditor and, by doing so, secures a right to be paid from the secured property ahead of all other unsecured creditors. Depending on the time at which and the circumstances under which such a transaction was effected, the policy of an insolvency law may be to avoid and invalidate such a transaction.

45. The policy issue is whether such avoidance provisions should apply to secured transactions. There may, of course, be a view that these types of transactions should not attract avoidance because they may be commercially justified. Indeed, the Secured Transactions Team took the position that any interference with the rights of secured creditors was wrong; and that if insolvency laws pose threats to lenders, reasonable lenders might well decide not to lend.⁸ However, that questions the soundness and justifiability of the general policies behind such avoidance laws. It does not justify a claim that a secured transaction should in all circumstances be exempt or distinguished from other transactions.

46. No argument was advanced during the Joint Session that possible avoidance of secured transactions in specified cases might in some way weaken or undermine the policy of endeavoring to ensure that a secured transactions regime was certain, predictable and safe. There does not appear to be any policy reason why a secured transaction should not be subject to the same rules of potential avoidance as any other commercial transaction. There is no justification for any exception to be made or for any immunity simply because the transaction was a secured transaction. If the rules of potential avoidance are known and clearly stated, they should apply to all transactions.

47. Effect on Secured Property Enforcement and other Rights and Powers. This appears to be the area of greatest potential conflict. It should, however, be stated at the outset that if the law follows a policy that, in general, a perfected secured property interest will be recognized in an insolvency, then there should be no question about any interference with or avoidance of the substance of such a security interest. Rather, what is at issue here is whether the enforcement rights and powers of a security holder in relation to the secured property might be interfered with.

48. On that issue a number of matters need to be considered, as follows:

- First, if security or enforcement action or proceedings have been commenced in respect of secured property before the commencement of the insolvency administration, should they be halted or suspended.
- Secondly, should the initiation of enforcement action be stayed or suspended as a result of the commencement of insolvency proceedings.

⁸ The Insolvency Team posited that the claims of potentially dire consequences might well be illusory. For example, it was noted that much of the data presented by the Secured Transactions Team is drawn from the US. The US is in fact far from being a secured creditors' paradise as the insolvency laws feature avoidance and stay provisions which curtail the rights of secured creditors. Nevertheless, the data shows that the United States has about the lowest interest rates and that creditors continue to lend. Moreover, seventy percent of the credit in the US is nevertheless secured. There was agreement between both Teams that further investigation on this point would be useful.

- Thirdly, for what length of time should any such suspension of enforcement extend.
- Fourthly, should any conditions apply to such suspension and may it be lifted or modified.
- Fifthly, who should have the conduct of the enforcement procedure and the sale of the secured property?

49. It is best to consider these issues in the context of the type of insolvency proceedings -liquidation (or bankruptcy) proceedings and reorganization proceedings. However, some general observations should first be made regarding justification or otherwise for interference with the enforcement powers of a secured creditor.

50. Contractual and Commercial Issues. A secured transaction is like any other transaction founded on a contract. The rights and obligations of the parties to a secured transaction will be largely set out in the contract (and possibly enhanced, regulated or controlled by a secured transactions law). The contract will include a right for the creditor to foreclose on, realize and otherwise deal with the secured property in the event of default in repayment of the loan or other money obligation of the debtor.

51. The contractual right to enforce a secured debt payment obligation by the sale of the secured property is an important right. It is primarily for this that a secured creditor and the debtor will, at least in a notional sense, have bargained. The considerations involved in striking such a bargain may include:

- the availability of loan funding at all;
- the amount of the loan;
- the terms and conditions of the financing (such as the term or length of the loan, repayment conditions); and
- the rate of interest for the loan.

52. The available economic data strongly suggests that it may be expected that secured financing is more available and at a lower cost than unsecured financing.

53. It is in the area of enforcement of a secured debt payment obligation by the sale of the secured property that the importance of a developed, efficient, predictable and safe secured transactions regime may be most appreciated. Unless such a regime exists, the availability, cost and the terms of borrowing are likely to be considerably higher and more restrictive. The availability and cost of borrowing will, to a large degree, correlate to the probability that a secured lender will be paid expeditiously and efficiently from the proceeds of the secured property. That involves enforcement rights and powers.

54. Interference with Commercial Practices and Contractual Rights. If an insolvency law is to promote the policy of an ordered, collective process and the fundamental principle of *pari passu* sharing between creditors, it has to intervene and restrict, limit and prohibit enforcement of individual creditor contractual rights. The law reinforces that interference by stopping debt recovery or collection practices. The law converts contractual rights into a collective right to claim and share in the estate of the debtor.

55. That position has long been accepted as justified in the case of unsecured creditors. It was developed and applied for the purpose of liquidation or bankruptcy because under that process it can be expected that the business of an insolvent debtor will be terminated and the property of a debtor dismembered and sold. The rights of secured creditors were not

normally interfered with or restricted in such a case because there was no justification for converting individual secured creditor rights into collective rights. Thus under the traditional form of liquidation or bankruptcy regime there was little or no interference with the contractual rights of a secured creditor.

56. However, the more recent development of the concept of “rescue” or corporate reorganization has resulted in the development of other policies and principles that in most cases extend to reach secured creditors, by, for example, automatically suspending the enforcement rights of secured creditors for some period of time during which the prospect of a “rescue” may be investigated. The justification is largely economic but, to a degree, is capable of being translated into collective policy principles. Greater benefit may be obtained by keeping the component parts of the business operations of an insolvent corporation together. That opportunity cannot be taken if the property can be sold off and dismembered by creditors (including secured creditors) in exercise of their individual contractual enforcement rights. For a secured creditor, the prospect of some restraint on enforcement rights affecting all secured creditors may be considered, in some cases, to have some collective advantages.

57. Except in some jurisdictions where it is possible to secure all the property of a corporation under the one secured transaction (for example, through the device known as the “fixed and floating charge” as practiced in some common law jurisdictions), it will normally be the case that a secured creditor will have security over only part of the property of the debtor. The value of that property may be greater if it and the other property can be retained together or sold or transferred together. As an example, consider a security over plant and equipment of a manufacturing corporation. It may be extremely doubtful that the dismemberment, removal and sale of such property will produce as great a value for it than if it was retained as part of the property of a business that was sold as a going concern.

58. The justification is that greater benefit may be obtained by keeping the component parts of the business operations of an insolvent corporation together. The opportunity to obtain a greater economic benefit cannot be taken if the property of the corporation can be sold off and dismembered by creditors in exercise of their individual contractual enforcement rights. Therefore, it is at least necessary to impose some type of temporary restraint on the exercise of those contractual and other rights for the purpose of (a) determining whether reorganization is a possibility; and (b) promoting and obtaining agreement to a plan of reorganization.⁹

59. This promotion of the possibility of reorganization also serves another purpose. It encourages corporations that are in financial difficulty to volunteer for such a process. If the reorganization law limits the prospect of piece meal dismemberment by individual creditor enforcement action, there is a greater incentive for corporations to seek reorganization.

60. Another benefit (and aim) of a possible reorganization may be to turn the business of a corporation around to produce profits and the necessary income to enable debts and other money obligations to be eventually satisfied. A secured creditor, though just as interested in being paid as any other creditor, will normally not have the power to control and manage a corporation to turn it around (an exception is found in jurisdictions that permit an all embracing fixed and floating charge and the appointment of a receiver by the secured creditor to manage the debtor corporation). A reorganization will normally result in

⁹ It should be noted that one of the basic tenets of RETA 5773 is that there is little evidence of economic gain resulting from reorganizations in general (and from Chapter 11 proceedings in the United States (US) in particular. It was argued that a “market-based mechanisms that convert lenders into shareholders are more efficient and may ultimately be no less socially progressive and equitable than judicially-administered reorganization proceedings.” RETA 5773 Report, p. 18. It was also argued that the effect of the duration of temporary restraint upon secured lending should be further examined.

management by a skilled and experienced administrator. Secured creditors need to be involved in the reorganization process and, at the same time, restrained from enforcing their rights against the secured property.

61. Both Teams at the Joint Session agreed that it would be best to determine the length of restraint on secured creditors on the basis of practical experience, rather than ad hoc or doctrinaire legal edicts. The issue can now be examined according to whether the insolvency will result in liquidation or a possible reorganization.

62. Upon Commencement. In jurisdictions that follow a unitary corporate insolvency system there will be a single commencement entry followed by a determination of whether the form of administration should be liquidation or a possible reorganization.¹⁰ Up to the time at which that determination is made it is desirable that enforcement action by a secured creditor should be suspended and restrained. Otherwise, it may not be possible to promote a reorganization if the process of dismemberment has commenced and is allowed to continue. However, this should be a quick and decisive process.

63. In jurisdictions that follow a modified unitary system, there will be either an entry into the liquidation process or the reorganization process, with the possibility of conversion from reorganization to liquidation if it is determined that reorganization is not possible. The issue of suspension of secured creditor enforcement rights should, accordingly, be determined by whether liquidation or reorganization is the end result of the process.

64. In Case of a Liquidation. Once it is determined that an insolvent debtor is to be liquidated, it is suggested, for the reasons given earlier, that there should be no restraint or restriction on the exercise of secured creditor enforcement rights against the secured property. There is no real justification for any such restraint. However, for the sake of efficiency, such claims should be dealt with in the same court to prevent conflicting judgments and forum shopping, etc., as indeed is provided by many liquidation regimes.

65. In Case of a Reorganization. For as long as a real prospect exists that the affairs of the debtor might be reorganized it is suggested that there should be a restraint on the exercise of individual secured creditor enforcement rights. If enforcement has already commenced but is not complete, the restraint should suspend the enforcement process.

66. The period of restraint should be for a limited, and certain period of time, but it may be necessary to enable such time periods to be extended by a court order in complex cases. The restraint should be capable of being lifted on the application of a secured creditor if it can be shown that the restraint is unnecessary or is causing irreparable damage to the secured creditor.

67. Secured creditors should be afforded the opportunity to consider and vote on a proposed reorganization plan or similar. The issue of whether a secured creditor should be bound to a plan is dealt with in a later section.

68. Conduct of Security Enforcement Powers. In some of the Economies, the commencement of an insolvency administration has the effect of requiring the sale of secured property to be conducted by the person administering the insolvency. It is difficult to appreciate why this is necessary. Once any restraint on the exercise of secured property enforcement powers has lapsed there is no reason why a secured creditor should not be able to employ enforcement rights outside of the insolvency administration. It is suggested,

¹⁰ For a fuller discussion on the pure unitary and modified unitary approach, see Section IV.C., Insolvency Law Reform in the Asian and Pacific Region, *supra*, at 29.

therefore, that the actual exercise of realization rights should not be withheld from the secured creditor.

69. If, in some jurisdictions, it is considered necessary that a liquidator or similar functionary should exercise realization and sale powers, the insolvency law should make it clear that the proceeds of the sale of secured property should belong to and be paid to the secured creditor.

70. Preferential Creditor Rights. The final issue in this section concerns whether preferential creditors should be entitled to be paid from the proceeds of secured property.

71. Preferential rights are created primarily in response to taxation and employment concerns and policies of government.¹¹ They usually afford protection to government and protection to workers. The justification for them is highly debatable (in a number of jurisdictions the debate has disappeared as the priority rights have been abolished), but it is not appropriate here to engage in that debate.¹² However, and assuming that the claims of some creditors should be given priority of payment ahead of other creditors, it is suggested that any such priority should be confined to a priority over those creditors whose rights are not secured, and who therefore, cannot have any expectation of priority.

72. In jurisdictions that provide for the fixed and floating charge form of secured transaction, a creditor who has security rights over all the property of a corporation may be required to satisfy preferential creditors from the proceeds of the secured property. But this might be justified on the ground that it is similar to a private quasi-liquidation and preferential creditor rights should not be excluded.

73. Aside of that exception, there does not appear to be any fundamental reason why the rights of secured creditors should be affected by preferred creditor rights. To so affect them can only result in uncertainty and a lack of predictability. It is likely to affect the cost of secured transaction borrowing. It is suggested, therefore, that claims of preferred creditors should not be entitled to payment in priority to the claims of secured creditors. C. Post-Insolvency

74. This part reviews possible issues that arise subsequent to the commencement of a formal insolvency administration that concern secured property interests. The issues include the effect of a plan of reorganization on secured property and the possible use of secured property to finance the provision of urgently required working capital requirements of an insolvent debtor.

75. Binding Secured Creditors and Secured Property to a Reorganization. In most cases a plan of reorganization will require the continued availability and use of the property of a corporation. This will include secured property. It may be expected that the plan will, as far as possible, incorporate consensual arrangements or agreements between secured creditors and the plan administrator or debtor regarding the secured property and the rights and powers of the secured creditors under the plan. If it is not possible to obtain such consensual arrangements, then the question is to what extent may a plan be imposed upon a secured creditor?

¹¹ For a fuller discussion on preferential rights, see, *Insolvency Law Reform in the Asian and Pacific Region*, *supra*.

¹² By way of brief examples, it is debatable whether preferential creditor rights should be accorded to government tax liens. The argument against affording such rights is that this encourages inefficient government tax collection systems. Similarly, granting workmen's compensation such preferential rights may be one disincentive to the promotion of efficient social safety net systems.

76. This is a far different position from imposing some form of temporary restraint upon the exercise of secured property enforcement rights during the period that it may take to determine if a corporate debtor may be reorganized, for which there may be some pragmatic economic and other justification as mentioned earlier. The same justifications are not entirely appropriate here.

77. The policy should have full regard for the rights of a secured creditor. There are a variety of different approaches in a number of jurisdictions. Some favor automatic imposition of a plan on all secured creditors if the majority of a secured creditor class has voted affirmatively for a plan. Others favor no imposition other than by a consensual arrangement. A middle course approach is one that only imposes a plan upon a dissenting secured creditor if a court makes an order to that effect. In such a case, it is generally necessary for the proponent of a plan to show that the rights of the secured creditor are protected by the plan and that the position of the secured creditor will not further deteriorate under or as a result of the plan (for example, that payments of future interest will be made and the value of the security will not be affected).

78. There is no convenient solution to the issue. Again, it is clearly important to take proper and full account of the effect of a radical approach upon the availability and cost of secured transaction financing and to provide for as much certainty and predictability as possible.

79. Financing of "New Money." The local studies carried out under RETA 5795 exposed the problem of providing urgently required working capital requirements for a corporation that is seeking a reorganization.¹³ The problem arises in part because very few insolvency law regimes make any provision to both sanction and protect the repayment of loans provided after the commencement of a formal insolvency administration.

80. In relation to secured transactions, the issue necessarily involves a consideration of the possibility of imposing additional or further security on existing secured property interests for the purpose of protecting a lender of new money. Specifically, should an insolvency law provide for a form of "secured priority" for a lender of new money which would have the effect of giving that lender priority over existing secured creditors?

81. The discussion on this issue in the Joint Session left no doubt that such a bald prospect would be regarded as seriously damaging to a secured transactions regime. It was argued that this would undermine predictability and create uncertainty. While there was ultimately support for the general policy that a debtor genuinely seeking to rehabilitate should have access to "new money" and that security would be needed for such "new money," there was less support for the mechanisms to regulate such transactions.

82. The provision of security for "new money" might be made less offensive by a requirement that such a priority might only be created by consensual agreement with existing secured creditors or by a court order after a careful review of the effect upon existing secured property interests. The general sentiment of participants at the Joint Session was that such a prospect needs to be further examined and assessed.

III. Conclusion and Recommendations

83. In the area of creation, registration and enforcement of secured property interests there is a high degree of compatibility between secured transactions and insolvency. Indeed, most of the aims of a developed secured transactions regime in this area would benefit an insolvency law regime and certainly not adversely affect it.

¹³ For a fuller discussion of "new money," see *Insolvency Law Reform in the Asian and Pacific Region*, supra.

84. In respect of the initial effects of a formal insolvency administration upon secured property interests, there is high compatibility concerning:

- recognition of the substantive rights of secured property interests in an insolvency of the debtor;
- lessening and, hopefully, removing the effect of unsecured creditor priority rights on secured property interests; and
- non-intrusion into secured property enforcement rights in a case of liquidation or bankruptcy.

85. There may be less compatibility concerning the treatment of secured property enforcement rights in a case of reorganization, but that may be greatly lessened if the insolvency regime provides for sensible limits on the period and the conditions of restraint and also provides for the possibility of application by a secured creditor for the lifting of the restraint.

86. The prospect of long term continued or further effects upon secured property interests under a plan of reorganization has the potential to cause considerable tension with a secured transactions regime unless the interests of the secured creditor are properly protected. The prospect of creating a priority over existing secured lenders for the purpose of providing urgent working capital funding for an insolvent corporation would require very careful consideration and should not be proposed without taking full account of the possible seriously damaging effect upon secured financing generally.

87. Future Development. It is suggested that reform to any insolvency law system must be carried out with due consideration of the secured transactions system, as both are part of the same system of legal and commercial regulation. Any weakness in one area poses an unhealthy burden on the other. Therefore, it is suggested that an integrated approach should be adopted for the reform of insolvency and secured transactions laws. Further, it is suggested that the issues considered in this report be taken into account in framing good practice guidelines for the development of both secured transactions legal regimes and insolvency law regimes in the Economies.