

# YEARBOOK

Volume XXXV: 2004





UNITED NATIONS COMMISSION ON  
INTERNATIONAL TRADE LAW

YEARBOOK

Volume XXXV: 2004



UNITED NATIONS  
New York, 2007

## NOTE

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

The footnote numbering follows that used in the original documents on which this *Yearbook* is based. Any footnotes added subsequently are indicated by lower-case letters.

Changes of and additions to wording that appeared in earlier drafts of conventions, model laws and other legal texts are in italics, except in the case of headings to articles, which are in italics as a matter of style.

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## INTRODUCTION

This is the thirty-fifth volume in the series of *Yearbooks* of the United Nations Commission on International Trade Law (UNCITRAL).<sup>1</sup>

The present volume consists of three parts. Part one contains the Commission's report on the work of its thirty-seventh session, which was held in New York, from 14-25 June 2004, and the action thereon by the United Nations Conference on Trade and Development (UNCTAD) and by the General Assembly.

In part two most of the documents considered at the thirty-seventh session of the Commission are reproduced. These documents include reports of the Commission's Working Groups as well as studies, reports and notes by the Secretary-General and the Secretariat. Also included in this part are selected working papers that were prepared for the Working Groups.

Part three contains the Legislative Guide on Insolvency Law, Explanatory Note on the United Nations Convention on the Assignment of Receivables in International Trade, bibliography of recent writings related to the Commission's work, a list of documents before the thirty-seventh session and a list of documents relating to the work of the Commission reproduced in the previous volumes of the *Yearbook*.

**UNCITRAL secretariat**  
**Vienna International Centre**  
**P.O.Box 500, 1400 Vienna, Austria**  
**Telephone: (+43-1) 26060-4060 Telex: 135612 Telefax: (+43-1) 26060-5813**  
**E-Mail: [uncitral@uncitral.org](mailto:uncitral@uncitral.org) Internet: <http://www.uncitral.org>**

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<sup>1</sup> To date the following volumes of the *Yearbook of the United Nations Commission on International Trade Law* (abbreviated herein as *Yearbook* [year]) have been published:

<i>Volume</i>	<i>Years covered</i>	<i>United Nations publication Sales No.</i>
I	1968-1970	E.71.V.1
II	1971	E.72.V.4
III	1972	E.73.V.6
III Suppl.	1972	E.73.V.9
IV	1973	E.74.V.3
V	1974	E.75.V.2
VI	1975	E.76.V.5
VII	1976	E.77.V.1
VIII	1977	E.78.V.7
IX	1978	E.80.V.8
X	1979	E.81.V.2
XI	1980	E.81.V.8
XII	1981	E.82.V.6
XIII	1982	E.84.V.5
XIV	1983	E.85.V.3
XV	1984	E.86.V.2
XVI	1985	E.87.V.4
XVII	1986	E.88.V.4
XVIII	1987	E.89.V.4
XIX	1988	E.89.V.8
XX	1989	E.90.V.9
XXI	1990	E.91.V.6
XXII	1991	E.93.V.2
XXIII	1992	E.94.V.7
XXIV	1993	E.94.V.16
XXV	1994	E.95.V.20
XXVI	1995	E.96.V.8
XXVII	1996	E.98.V.7
XXVIII	1997	E.99.V.6
XXIX	1998	E.99.V.12
XXX	1999	E.00.V.9

<i>Volume</i>	<i>Years covered</i>	<i>United Nations publication Sales No.</i>
XXXI	2000	E.02.V.3
XXXII	2001	E.04.V.4
XXXIII	2002	E.05.V.13
XXXIV	2003	.....

*Part One*

**REPORT OF THE COMMISSION  
ON ITS ANNUAL SESSION  
AND COMMENTS AND ACTION THEREON**



# THE THIRTY-SEVENTH SESSION (2004)

## A. Report of the United Nations Commission on International Trade Law on its thirty-seventh session (New York, 14-25 June 2004)

(A/59/17) [Original: English]

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## I. Introduction

1. The present report of the United Nations Commission on International Trade Law (UNCITRAL) covers the thirty-seventh session of the Commission, held in New York from 14 to 25 June 2004.
2. Pursuant to General Assembly resolution 2205 (XXI) of 17 December 1966, the report is submitted to the General Assembly and is also submitted for comments to the United Nations Conference on Trade and Development.

## II. Organization of the session

### A. Opening of the session

3. The thirty-seventh session of the Commission was opened on 14 June 2004.

### B. Membership and attendance

4. The General Assembly, in its resolution 2205 (XXI) established the Commission with a membership of 29 States, elected by the Assembly. By its resolution 3108 (XXVIII) of 12 December 1973, the Assembly increased the membership of the Commission from 29 to 36 States. By its resolution 57/20 of 19 November 2002, the General Assembly further increased the membership of the Commission from 36 States to 60 States. The current members of the Commission, elected on 16 October 2000 and 17 November 2003, are the following States, whose term of office expires on the last day prior to the beginning of the annual session of the Commission in the year indicated:<sup>1</sup> Algeria (2010), Argentina (2007), Australia (2010), Austria (2010), Belarus (2010), Belgium (2007), Benin (2007), Brazil (2007), Cameroon (2007), Canada (2007), Chile (2007), China (2007), Colombia (2010), Croatia (2007), Czech Republic (2010), Ecuador (2010), Fiji (2010), France (2007), Gabon (2010), Germany (2007), Guatemala (2010), India (2010), Iran (Islamic Republic of) (2010), Israel (2010), Italy (2010), Japan (2007), Jordan (2007), Kenya (2010), Lebanon (2010), Lithuania (2007), Madagascar (2010), Mexico (2007), Mongolia (2010), Morocco (2007), Nigeria (2010), Pakistan (2010), Paraguay (2010), Poland (2010), Qatar (2007), Republic of Korea (2007), Russian Federation (2007), Rwanda (2007), Serbia and Montenegro (2010), Sierra Leone (2007), Singapore (2007), South Africa (2007), Spain (2010), Sri Lanka (2007), Sweden (2007), Switzerland (2010), Thailand (2010), the former Yugoslav Republic of Macedonia (2007), Tunisia (2007), Turkey (2007), Uganda (2010), United Kingdom of Great Britain and Northern Ireland (2007), United States of America (2010), Uruguay (2007), Venezuela (2010) and Zimbabwe (2010).

5. With the exception of Argentina, Benin, Ecuador, Fiji, Gabon, Israel, Lebanon, Paraguay, Poland, South Africa, the former Yugoslav Republic of Macedonia, Uruguay and Zimbabwe, all the members of the Commission were represented at the session.

6. The session was attended by observers from the following States: Bolivia, Cambodia, Denmark, Greece, Holy See, Indonesia, Kuwait, Libyan Arab Jamahiriya, Philippines, Saudi Arabia, Slovakia, Ukraine and Viet Nam.

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<sup>1</sup> Pursuant to General Assembly resolution 2205 (XXI), the members of the Commission are elected for a term of six years. Of the current membership, 17 were elected by the Assembly at its fifty-fifth session, on 16 October 2000 (decision 55/308), and 43 were elected by the Assembly at its fifty-eighth session, on 17 November 2003 (decision 58/407). By its resolution 31/99, the Assembly altered the dates of commencement and termination of membership by deciding that members would take office at the beginning of the first day of the regular annual session of the Commission immediately following their election and that their terms of office would expire on the last day prior to the opening of the seventh regular annual session of the Commission following their election.

7. The session was also attended by observers from the following international organizations:

(a) *United Nations system*: World Bank, International Monetary Fund and World Intellectual Property Organization;

(b) *Intergovernmental organizations*: Asian-African Legal Consultative Organization, European Community and International Cotton Advisory Committee;

(c) *Non-governmental organizations invited by the Commission*: American Bar Association, American Bar Foundation, Arab Union for International Arbitration, Cairo Regional Centre for International Commercial Arbitration, Center for International Legal Studies, Forum for International Commercial Arbitration, Global Center for Dispute Resolution Research, Groupe de réflexion sur l'insolvabilité et sa prévention, Institute of International Banking Law and Practice, INSOL International, International Bar Association, International Insolvency Institute, International Law Institute and Union internationale des avocats.

8. The Commission welcomed the participation of international non-governmental organizations with expertise in the major items on the agenda. Their participation was crucial for the quality of texts formulated by the Commission and the Commission requested the Secretariat to continue to invite such organizations to its sessions (see also paras. 114, 116 and 117 below).

### C. Election of officers

9. The Commission elected the following officers:

*Chairman*: Wisit Wisitsora-At (Thailand)

*Vice-Chairmen*: Ricardo Sandoval López (Chile)  
Petar Šarčević (Croatia)  
Simon Onekutu (Nigeria)

*Rapporteur*: David Morán Bovio (Spain)

### D. Agenda

10. The agenda of the session, as adopted by the Commission at its 776th meeting, on 14 June 2004, was as follows:

1. Opening of the session.
2. Election of officers.
3. Adoption of the agenda.
4. Finalization and adoption of the draft UNCITRAL Legislative Guide on Insolvency Law.
5. Arbitration: progress report of Working Group II.
6. Transport law: progress report of Working Group III.
7. Electronic commerce: progress report of Working Group IV.



8. Security interests: progress report of Working Group VI.
9. Possible future work in the area of public procurement.
10. Monitoring implementation of the 1958 New York Convention.
11. Case law on UNCITRAL texts, digests of case law on the United Nations Sales Convention and other uniform texts.
12. Training and technical assistance. Follow-up to in-depth evaluation of work of the Commission's secretariat concerned with training and technical assistance.
13. Status and promotion of UNCITRAL legal texts.
14. Relevant General Assembly resolutions.
15. Coordination and cooperation. Follow-up to in-depth evaluation of work of the Commission's secretariat concerned with coordination and cooperation.
16. Other business.
17. Date and place of future meetings.
18. Adoption of the report of the Commission.

#### **E. Adoption of the report**

11. At its 787th, 792nd and 793rd meetings, on 21 and 25 June 2004, the Commission adopted the present report by consensus.

### **III. Finalization and adoption of the draft UNCITRAL legislative guide on insolvency law**

#### **Part One. Designing the key objectives and structure of an effective and efficient insolvency law**

12. The Commission considered the recommendations and commentary (A/CN.9/WG.V/WP.70 (Part I)), the revisions to the recommendations proposed (A/CN.9/559/Add.1) and the revisions to the commentary proposed (A/CN.9/559/Add.2).

13. The Commission approved the substance of part one of the draft guide, including the amendments proposed (A/CN.9/559/Add.1 and 2), with the following revisions:

(a) Deletion of the words "other than judicial authorities" in the last sentence of paragraph 4 of document A/CN.9/559/Add.2;

(b) Addition at the end of paragraph 9 (A/CN.9/WG.V/WP.70 (Part I)) of words along the lines of the following: "To the extent that a debtor is excluded from the scope of such legal mechanisms, it and its creditors will not be subject to the

discipline of the mechanism, nor will they enjoy the protections afforded by the mechanism”;

(c) Substitution of the word “minimized” for “avoided” in the last sentence of paragraph 21 (A/CN.9/WG.V/WP.70 (Part I)) to address the concern that the last sentence of the paragraph was inconsistent with the real importance of social and political concerns to insolvency law and should be revised;

(d) Addition at the beginning of paragraph 75 (A/CN.9/WG.V/WP.70 (Part I)) after the words “an insolvency law can” of words along the following lines: “assign specific functions to other participants, such as the insolvency representative and creditors, or to some other authority, such as an insolvency or corporate regulator”;

(e) Addition of a short, general summary at the end of part one of work being undertaken by international organizations in the area of building institutional capacity, as requested by Working Group V (Insolvency Law) at its thirtieth session (see A/CN.9/551, para. 115).

14. The concern was raised as to whether the last sentence of paragraph 41 of document A/CN.9/WG.V/WP.70 (Part I) should be construed as meaning that a subordination agreement entered into prior to insolvency would be void once insolvency proceedings commenced. The Commission noted that Working Groups V and VI had agreed (see A/CN.9/550, para. 20) that, as a general principle, subordination agreements should be respected in insolvency, but that parties could not agree to a higher ranking than provided for under the insolvency law. It was also noted that the substance of that conclusion was to be reflected in part two, chapter V, section B, of the draft guide dealing with priorities and it was agreed that an appropriate note could be added to paragraph 41.

## **Part Two. Core provisions for an effective and efficient insolvency law**

15. The Commission considered the recommendations and commentary (A/CN.9/WG.V/WP.70 (Part II)), as well as the proposed amendments to the recommendations and the commentary (A/CN.9/559/Add.1-3).

16. The Commission approved the substance of chapter I, section A, “Eligibility and jurisdiction”, including the amendments proposed (A/CN.9/559/Add.1), and agreed that footnote 1 to paragraph 87 of document A/CN.9/WG.V/WP.70 (Part II), if appropriately amended, should be retained to explain the scope of the term “economic activities” as used in the draft guide.

17. The Commission approved the substance of chapter I, section B, “Commencement of proceedings”, including the amendments proposed (A/CN.9/559/Add.1), and agreed that the commentary should make it clear that recommendation 13, subparagraph (b), as amended, stated the principal courses of action open to the debtor, but was not intended to be exhaustive. The Commission approved the addition at the end of paragraph 143 of document A/CN.9/WG.V/WP.70 of words along the following lines: “Creditors other than those applying for commencement of proceedings may have a direct interest in being notified of the commencement of those proceedings.”

18. The Commission approved the substance of chapter I, section C, “Applicable law governing in insolvency proceedings”, including the amendments proposed (A/CN.9/559/Add.1), noting that Working Group V had agreed to relocate recommendation 179, previously included in the chapter on applicable law, to part one of the draft guide and to replace the words “general law” with “law other than the insolvency law” to ensure consistency throughout the draft guide.

19. The Commission approved the substance of chapter II, section A, “Assets constituting the insolvency estate”, including the amendments proposed (A/CN.9/559/Add.1).

20. The Commission approved the substance of chapter II, section B, “Protection and preservation of the insolvency estate”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Revision of the heading of recommendation 31 to reflect its content more accurately;

(b) Revision of recommendation 33 to include termination of provisional measures when successfully challenged under recommendation 31;

(c) Reversal of the order of recommendations 38 and 39;

(d) Deletion of the square brackets and retention of the suggested text in recommendations 27, subparagraph (d), and 38;

(e) Addition at the end of paragraph 215 of words along the following lines: “This approach avoids some of the complexities associated with ongoing valuation of the encumbered assets that may be required under the first approach noted above.”

21. In response to the concern that recommendation 34, subparagraph (b), as revised (A/CN.9/559/Add.1), should not apply to prevent enforcement of a security interest in liquidation, it was noted that that concern could be addressed under recommendation 35, which contemplated possible exceptions to the stay.

22. The Commission approved the substance of chapter II, section C, “Use and disposal of assets”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Deletion of the words “and assets owned by a third party” from subparagraph (a) of the purpose clause (see A/CN.9/559/Add.1) and insertion of a new subparagraph along the lines of “permit and specify the conditions for the use of assets owned by a third party”;

(b) Retention of all the square bracketed text in recommendation 40B, subparagraph (b), without the brackets;

(c) Retention of the references to both “use” and “disposal” in recommendation 43A and clarification in the commentary that the secured creditor referred to in subparagraph (a) must have a security interest that covered the cash proceeds;

(d) Addition before the last sentence of paragraph 234 of words along the following lines: “Where an asset is relinquished to a secured creditor by an

insolvency representative, the insolvency law might provide that the secured creditor's claim is reduced by the value of the relinquished asset".

23. Concern was expressed that the obligation to provide notice to all creditors in recommendation 41 might prove onerous. The Commission noted that under recommendation 117 an insolvency law might provide for a creditor committee to have a role with respect to the sale of certain assets. It was agreed that, where that approach was adopted, notifying the creditor committee would satisfy the notice requirement of recommendation 41 and that that clarification should be included in the commentary to section C. It was also agreed that reference to "sale of significant assets" in recommendation 117 should be revised to refer to sales "outside the ordinary course of business".

24. The Commission approved the substance of chapter II, section D, "Post-commencement finance", including the amendments proposed (A/CN.9/559/Add.1 and 2), with the following revisions:

(a) Amendment of the last sentence of recommendation 49 to provide that the insolvency law might require the court to authorize creditors (or the creditor committee) to consent to the provision of post-commencement finance;

(b) Addition at the end of paragraph 243 of words along the following lines: "This risk must be balanced against the prospect that preservation of going concern value by continued operation of the business will benefit those creditors".

25. The Commission approved the substance of chapter II, section E, "Treatment of contracts", including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Inclusion of a reference to acceleration clauses in recommendation 56 and the relevant paragraphs of the commentary;

(b) Removal of the square brackets and retention of the words "be heard by the court" in recommendation 62;

(c) Removal of the square brackets and retention of the text in the *chapeau* to recommendation 66;

(d) Retention of the words "contractual price of the performance" in subparagraph (a) of recommendation 66 without square brackets and deletion of the reference to the "costs under the contract of the benefits conferred on the estate";

(e) Deletion of the text in square brackets in subparagraph (d) of recommendation 70.

26. In response to the view that recommendation 56 did not reflect the approach to automatic termination clauses adopted in many countries, it was recalled that the Working Group had decided to stress the importance of overriding such clauses to protection of the value of the insolvency estate and to ensuring the continuation of contracts for the benefit of reorganization. It was noted that further explanation of the reference to curing a breach in recommendation 65 might be included in the commentary.

27. The Commission approved the substance of chapter II, section F, "Avoidance proceedings", including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Retention of the reference to potential creditors in recommendation 73, subparagraph (a), and paragraph 314;

(b) Deletion of the first part of recommendation 80 up to the words “the insolvency law”;

(c) Deletion of the second sentence of recommendation 82 after the words “insolvency proceedings” on the basis that any transaction entered into before commencement might amount to a preference and a transaction entered into in a reorganization that preceded a liquidation would be a transaction entered into after commencement and not therefore subject to the suspect period;

(d) Substitution of the words “insolvency law” for the word “court” in the second sentence of recommendation 83;

(e) Addition at the end of paragraph 334 of words along the following lines: “With the exception of transactions involving wrongful behaviour, it is highly desirable therefore that suspect periods be of a reasonably short duration to ensure commercial certainty and to reduce any negative impact that avoidance provisions will have on the availability and cost of credit”;

(f) Insertion in paragraph 341 of a reference to the need to commence avoidance proceedings within a reasonably short period of time to avoid uncertainty and delay.

28. The Commission approved the substance of chapter II, section G, “Rights of set-off”.

29. The Commission approved the substance of chapter II, section H, “Financial contracts and netting”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Addition at the end of paragraph 360 of the following sentence: “The exceptions for financial contracts should be drafted broadly enough to protect the significant interests of parties that deal in financial contracts and to prevent systemic risk”;

(b) Addition in the first sentence of the purpose clause of the words “on financial markets” after the words “in the context of financial transactions”.

30. The Commission approved the substance of chapter III, section A, “The debtor”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Removal of the square brackets from the text in recommendation 96;

(b) Amendment of recommendation 97A along the following lines: “Where the debtor is a debtor in possession, the insolvency law should specify those functions of the insolvency representative that may be performed by the debtor in possession”, to avoid the implication that the debtor in possession must have all of the powers of an insolvency representative;

(c) Addition at the end of paragraph 376 of words along the following lines: “Where the insolvency law provides for a debtor to remain in control of the business, it is desirable that the law specify the powers and functions of an insolvency representative that may be exercised by that debtor in possession”;

(d) Addition of a reference to professional secrets in the first sentence of paragraph 387.

31. The Commission approved the substance of chapter III, section B, “The insolvency representative”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Addition at the end of recommendation 100, subparagraph (b), of words along the following lines: “or a person employed by the insolvency representative where the conflict of interest or the circumstances that may lead to a conflict of interest or lack of independence arise in the course of insolvency proceedings”;

(b) Removal of the square brackets from the text in recommendation 104;

(c) In paragraph 402, addition in the second sentence of the words “prior engagement as an auditor of the debtor” and at the end of the penultimate sentence of the words “including specifying those relationships that will disqualify a person from being appointed”.

32. The Commission approved the substance of chapter III, section C, “Creditors—participation in insolvency proceedings”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) In recommendation 112, removal of the square brackets from the proposed text in order to underline the importance of the insolvency law specifying the matters to be discussed at the first meeting of creditors, deletion of the word “certain” and addition of appropriate emphasis in the commentary on the need for the insolvency law to specify the matters to be discussed;

(b) As a matter of drafting, deletion of the word “generally” from the second sentence of recommendation 112 and addition of the words “any other” before “meeting of creditors”;

(c) In view of the discussion on recommendation 41 on use and disposal of assets, deletion of the words after “reorganization plan” in recommendation 117, subparagraph (b), and insertion of a new subparagraph along the lines of “receiving notice of and being consulted on matters in which their class has an interest, including the sale of assets outside the ordinary course of business”;

(d) In the first sentence of paragraph 443, addition of the words “or other form of creditor representation” after the words “creditors committee” and in the fourth sentence of paragraph 469, addition of the words “or taking advantage of confidential information received as a committee member” after the words “prior approval of the court”.

33. The Commission noted that the commentary relating to levels of participation and functions of creditors had been revised by the Secretariat to streamline the text.

34. The Commission approved the substance of chapter III, section D, “Party in interest’s right to be heard and to appeal”.

35. The Commission agreed that it might be useful to include, as an annex to the draft guide, a list of, or index to, those recommendations and paragraphs addressing the treatment of security interests in insolvency, based upon document A/CN.9/WG.V/WP.71.

36. The Commission approved the substance of chapter IV, section A, “The reorganization plan”, including the amendments proposed (A/CN.9/559/Add.3), with the following revisions:

(a) In recommendation 126, deletion in the first sentence of the words from “submitted” to “vote on approval” to focus the recommendation on preparation of the disclosure statement and addition of the word “disclosure” before “statement” in the second sentence;

(b) In recommendation 127, deletion of the word “those” in square brackets and the words following “equity holders” at the end of the sentence, to ensure that the plan and disclosure statement are available more widely than just to those who may be entitled to vote on approval of the plan or whose rights are affected or modified by the plan;

(c) In recommendation 128, subparagraphs (a) and (b), removal of the square brackets and retention of the text; deletion of subparagraph (c) and the associated footnote 91a; and removal of the square brackets and retention of the text in subparagraph (f). It was noted that the manner in which assets of the debtor were to be treated in the plan was intended to be covered under subparagraph (d) of recommendation 128;

(d) In recommendation 129, subparagraph (a), removal of the square brackets and retention of the text and amendment of the text along the lines of a “summary” or “description of the plan”; and in subparagraph (c), deletion of the example set forth in parentheses; in subparagraph (f), deletion of the first text in square brackets, and removal of the square brackets and retention of the second text in square brackets concerning adequate provision for satisfaction of the debtor’s obligations;

(e) In recommendation 130, inclusion of equity holders in the scope of the recommendation;

(f) In recommendations 130A-D, retention of the recommendations and deletion of the square brackets;

(g) In recommendation 130A, inclusion of equity holders in the scope of the recommendation, addition of the words “or affected” after “modified” and removal of the square brackets and retention of the text “the opportunity to vote”;

(h) In recommendation 130B, inclusion of equity holders in the scope of the recommendation and deletion of the word “adversely”;

(i) In recommendation 130C, amendment of the text along the following lines: “The insolvency law should specify that creditors entitled to vote on approval of the plan should be separately classified according to their respective rights and that each class should vote separately”;

(j) In recommendation 130D, inclusion of equity holders in the scope of the recommendation and retention of the word “treatment” without square brackets;

(k) In recommendation 133, deletion of the text in square brackets in the first sentence concerning modification of rights, and removal of the square brackets and retention of the text in the second sentence addressing approaches to approval and specifying a minimum standard for approval;

(l) In recommendation 134, deletion of the first text in square brackets concerning modification of rights, and removal of the square brackets and retention of the cross-reference to recommendation 138, subparagraphs (a)-(e);

(m) In recommendation 138, removal of the square brackets and retention of the text in subparagraph (a) relating to requisite approvals, removal of the square brackets and retention of the text providing that a creditor will receive “at least as much under the plan” in subparagraph (b), amendment of the reference to “contrary to the law” in subparagraph (c) to “contrary to law” and amendment of subparagraph (e) along the following lines: “Except to the extent that affected classes of creditors have agreed otherwise, if a class of creditors has voted against the plan, that class shall receive under the plan full recognition of its ranking under the insolvency law and the distribution to that class under the plan should conform to that ranking”;

(n) In recommendation 142, removal of the square brackets and retention of the text relating to the timing of amendment of the plan;

(o) In recommendation 143, deletion of the text in square brackets at the beginning of the second sentence, removal of the brackets and retention of both references to parties “affected by the modification” in the second sentence;

(p) In recommendation 145, deletion of subparagraph (b) on the basis that it might be interpreted as giving certain parties wide powers to apply for conversion without cause, in subparagraph (f) deletion of the square brackets and retention of the reference to breach “by the debtor” and amendment of the final words to “or an inability to implement the plan”. A proposal to add text to recommendation 145, subparagraph (f), to the effect that the court should first consider the possibility of modifying the reorganization plan before converting proceedings to liquidation did not obtain sufficient support.

37. A proposal was made to include a recommendation to the effect that “The insolvency law should specify that any class of creditors or equity holders that would receive no distribution under the plan would be deemed to have rejected the plan” in order to reduce costs and delay in soliciting approval of the plan and to invoke the protections applicable under the insolvency law to creditors voting against the plan. That proposal was not supported on the basis that creditors should not be deprived of their right to vote and that deeming those creditors to have voted against the plan might expose them to other liabilities.

38. The Commission approved the substance of chapter IV, section B, “Expedited reorganization proceedings”, including the amendments proposed (A/CN.9/559/Add.3), with the following revisions:

(a) In recommendation 146: amendment of subparagraph (a) to ensure that a debtor could apply for expedited proceedings not only when it was eligible to apply for reorganization under recommendation 9, but also when it could satisfy the commencement standard included in recommendation 146 by including the words “is or” at the beginning of subparagraph (a); deletion of the words “and by each affected creditor not part of a voting class” from subparagraph (b); and addition of a recommendation 146A along the following lines:

“The insolvency law may additionally specify that an expedited proceeding can be commenced on the application of any debtor if:



“(a) The debtor’s liabilities exceed or are likely to exceed its assets; and

“(b) The requirements of recommendation 146, subparagraphs (b) and (c), are satisfied.”

(b) In recommendation 147, in subparagraph (c), amendment of the reference to “preferential creditors” to “unaffected creditors”; deletion of the phrase “such as tax or social security authorities or employees”; removal of the square brackets, and retention of the first alternative text to require agreement of unaffected creditors to any modification of their rights;

(c) With respect to recommendation 149, it was noted that the opening words to subparagraph (b) were required to enable the court to apply the effects of commencement more broadly than affected creditors where, for example, measures were required to apply to other creditors to protect the insolvency estate;

(d) In recommendation 150, removal of the square brackets and retention of the references to “affected” creditors and deletion of the words at the end of the first sentence of the *chapeau*, “using existing available means”;

(e) In recommendation 151, alignment of subparagraph (c) with the amendments agreed with respect to the corresponding subparagraph (c) of recommendation 147.

39. The Commission approved amendment of recommendation 153 along the following lines: “The insolvency law may specify that where there is a substantial breach by the debtor of the terms of the plan or an inability to implement the plan, the court may close the judicial proceedings and parties in interest may exercise their rights at law.” It was also agreed that that text should be added as a new recommendation to follow recommendation 145, on the basis that there would be situations in which it would be appropriate to close the proceedings rather than to convert them to liquidation.

40. The Commission approved the substance of chapter V, section A, “Treatment of creditor claims”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Removal of the square brackets from the text in recommendation 162 and deletion of the words “to deny” at the end of the second sentence;

(b) Removal of the square brackets from the text in recommendation 163 and deletion of the words “to deny the claim”;

(c) In recommendation 169, substitution of the word “person” for “party” and substitution of the word “reduced” for “restricted” in subparagraph (b), in line with the discussion in paragraph 610 of the commentary;

(d) In paragraph 571, amendment of the third, fourth and fifth sentences along the following lines:

“Insolvency laws adopt different approaches to excluded claims. Under some laws, the creditors holding those claims cannot participate and have no recourse for collecting their debt from the debtor; their claim is effectively extinguished. Under other laws, however, alternative courses of recovery are preserved and the claim can be pursued outside the insolvency proceedings”;

(e) In paragraph 586, in the first sentence, addition of the words “required to be submitted under the insolvency law that are” after the words “different approaches to those claims”.

41. In response to a question as to whether non-monetary claims would be covered by recommendation 155, it was observed that the purpose of the recommendation as drafted was to emphasize the need for the insolvency law to specify the types of claim that should be submitted and to include some examples. As such, it was not intended to imply that non-monetary claims could not be submitted. It was noted that the matter could be clarified in the commentary.

42. The Commission approved the substance of chapter V, section B, “Priorities and distribution of proceeds”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Revision of the heading of recommendation 174 to “Ranking of claims other than secured claims”;

(b) Deletion of the second sentence of footnote 112, on the basis that the matter was appropriately addressed in the commentary at paragraph 633;

(c) Addition in paragraph 617 after “applicable law” of words along the following lines: “(which may provide for subordination of certain types of claim, for example, those of related persons)”;

(d) Addition at the end of paragraph 621 of words along the following lines: “The general principle of recognizing pre-commencement priorities should be interpreted to include priorities based upon a subordination agreement, provided the parties’ agreement is not to provide a ranking higher than otherwise would be accorded under the applicable law”;

(e) Addition of the word “treaty” between “international” and “obligations” in paragraph 631 and addition of the following words after “obligations”: “such as those applicable to employees claims, which are discussed further below”;

(f) Insertion of a full stop after the phrase “class of priority claims” in the first sentence of paragraph 633 and amendment of the following two sentences along the following lines: “In a number of cases those claims rank higher than other priority claims, and specifically above tax and social security claims, and in a few cases above secured claims (see paras. 625 and following above). The approach of providing priority for workers’ claims is generally consistent with the special protection that is afforded to employees in other areas of insolvency law (see chapter III.D.6) as well as with the approach of international treaties on protection of workers.<sup>111</sup>”;

(g) Insertion in the second sentence of paragraph 634 after “wage guarantee fund” of the following words: “or insurance scheme providing a separate source of funds to ensure the settlement of employees’ claims”.

43. The Commission approved the substance of chapter V, section C, “Treatment of corporate groups in insolvency”.

44. The Commission approved the substance of chapter VI, section A, “Discharge”, including the amendments proposed (A/CN.9/559/Add.1), with the following revisions:

(a) Amendment of the heading before recommendation 184 to “Discharge of a natural person debtor in liquidation”;

(b) Placement of the second sentence of recommendation 185 in a new recommendation and amendment of the text along the following lines: “Where the insolvency law provides that conditions may be attached to a debtor’s discharge, those conditions should be kept to a minimum to facilitate the debtor’s fresh start and be clearly set forth in the insolvency law”;

(c) Reversal of the order of paragraphs 653 and 654, insertion of the heading “(a) Where the debtor is a legal entity” before paragraph 654; insertion of the heading “(b) Where the debtor is a natural person” before paragraph 653; and addition of a third sentence to paragraph 653 along the following lines: “It should be noted that discharge of a natural person debtor generally does not affect the liability of a third party that has guaranteed the obligations of that debtor”.

45. The Commission approved the substance of chapter VI, section B, “Conclusion of proceedings”, including the amendments proposed (A/CN.9/559/Add.1) with the following revisions:

(a) Reversal of the order of recommendations 186 and 187 to reflect the emphasis accorded to reorganization throughout the draft guide;

(b) Deletion of the words following “closed” at the end of recommendation 187;

(c) Addition of a second sentence to paragraph 667 along the following lines: “It is desirable that the insolvency law specify the party that can apply for conclusion of proceedings, whether the application for conclusion and the decision to conclude should be publicized and whether creditors could be heard on the application”.

46. Those recommendations not specifically referred to in the present report were approved by the Commission without amendment.

47. The Commission approved those terms of the glossary set forth in document A/CN.9/551 and not finalized by Working Group V (Insolvency Law) at its thirtieth session, as follows:

(a) “Creditor”, “debtor in possession”, “ordinary course of business” “preference” and “related person”, without amendment;

(b) “Claim”, with the words “other theory of legal obligation” amended to “other type of legal obligation” and the word “assets” in the note retained without square brackets;

(c) “Commencement of proceedings”, with the words “The event determining the” deleted;

(d) “Netting”, with the word “mutual” deleted and the word “under” retained without square brackets;

(e) “Priority”, with the word “person” amended to “claim”;

(f) “Secured claim”, with the words after “debtor’s default” deleted;

(g) “Secured creditor”, with the text amended to “A creditor holding a secured claim”;

(h) “Security interest”, with the text amended to “A right in an asset to secure payment or other performance of one or more obligations”;

(i) “Voluntary restructuring negotiations”, with the words “resulting in” replaced with “aiming at”;

(j) “Fraudulent transfer” deleted.

48. The Commission approved those terms of the glossary set forth in document A/CN.9/WG.V/WP.70 (Part I) and not considered by Working Group V at its thirtieth session, as follows:

(a) “Reorganization”, “sale as a going concern” and “suspect period” without amendment;

(b) “Reorganization plan”, with the second and third sentences deleted;

(c) “Set-off”, with the second sentence deleted and “(balanced)” in the first sentence replaced with words along the lines of “applied in satisfaction or reduction”;

(d) “Stay of proceedings”, with the word “perfection” replaced with “actions to make a security interest effective against third parties”;

(e) “Unsecured creditor” replaced with “a creditor without a security interest” and the remainder of the definition deleted; and

(f) “Retention of title”, “secured debt”, “state-owned enterprise”, “superpriority” and “unsecured debt” deleted.

49. The Commission approved terms (a)-(i), (k)-(w) and (y) without amendment. Term (j), “encumbered asset”, was amended by deleting the word “obtained”; term (x), “post-commencement claim”, was amended by deleting the words “from an act or omission occurring”; term (z), “protection of value”, was amended to make the language conform to recommendation 39 and to refer to assets owned by third parties by replacing “a security interest” with “encumbered assets and assets owned by third parties”.

50. The Commission approved the following additions and revisions to the commentary of the draft guide to reflect the Commission’s deliberations and decisions on the recommendations:

(a) In part one of the draft guide, the addition of two notes on interpretation to the effect that:

(i) References to “person” should be interpreted as including both natural and legal persons, unless otherwise indicated;

(ii) “Creditors” should be interpreted as including both the creditors in the forum State and foreign creditors, unless otherwise specified;

(b) Addition of the term “court” to the glossary with the following definition: “A judicial or other authority competent to control or supervise an insolvency proceeding”;

(c) Addition of a footnote to paragraph 41, cross-referencing paragraph 621 on treatment of subordination agreements in insolvency;

(d) Revision of the first sentence of paragraph 58 to reflect amendments to part two, chapter IV, section B, on expedited reorganization proceedings along the following lines: “Since reaching agreement through voluntary restructuring negotiations is often impeded by the ability of creditors to take individual enforcement action and by the need for unanimous consent to alter the terms of some existing classes of debt, some countries have adopted different types of mechanism, including ‘pre-insolvency’ or ‘pre-packaged’ procedures, to address those situations. The expedited reorganization proceedings discussed in the Guide to address those situations follow the procedure of reorganization, but on an expedited basis, combining voluntary restructuring negotiations, where a plan is negotiated and agreed by a majority of affected creditors, with reorganization proceedings commenced under the insolvency law to obtain court confirmation of the plan in order to bind dissenting creditors”;

(e) In part two of the draft guide, revision of the fourth sentence of paragraph 116 concerning use of presumptions of insolvency, along the following lines: “There is a practical need for a creditor to be able to present proof, such as by way of a presumption, which establishes the insolvency of a debtor, without placing an unreasonably heavy burden of proof on creditors. A presumption that the debtor is generally unable to pay its debts might be established where, for example, the debtor fails to pay one or more of its debts, and the unpaid debt is undisputed, that is, not subject to a legitimate dispute or offset. Where the law provides for such a presumption, there is a corresponding need for the insolvency law to provide the debtor with an opportunity to rebut the presumption and specify the grounds upon which it might be rebutted. These grounds might include the debtor showing that it was able to pay its debts; that the debt was subject to a legitimate dispute; or any other negation of the elements by which a creditor established the presumption. Notifying a debtor of an application for commencement of insolvency proceedings by the creditor will allow the debtor the opportunity to dispute a creditor’s claims regarding its financial position (see also chapter I.B.5 (e))”;

(f) Addition of text at the end of paragraph 142 to address notification of foreign creditors, along the following lines: “A further consideration is whether to expressly address notification of foreign creditors in any notice requirements included in an insolvency law, to ensure the equal treatment of domestic and foreign creditors, and to take account of the international trend of abolishing discrimination based upon the nationality of the creditor. The factors to be balanced in determining that issue are discussed below in the context of the manner of giving notice”;

(g) Addition of text at the end of paragraph 143, to reflect changes to recommendation 13, paragraph (b), along the following lines: “The debtor would have various courses of action open to it, including consenting to the application, disputing the applicant’s claim as to its financial position, and requesting the commencement of different proceedings (e.g. where the application is for liquidation, requesting commencement of reorganization). The debtor may also have jurisdictional or procedural defences to a creditor application”;

(h) Addition of a sentence at the end of paragraph 148 along the following lines: “For example, where an application to commence insolvency proceedings

might otherwise be denied, some insolvency laws provide an exception for individuals with insufficient assets to fund the administration of proceedings, enabling the affairs of that debtor to be investigated to determine if there are assets that can be recovered and whether or not the debtor should receive a discharge”;

(i) Addition after the first sentence of paragraph 170 of text along the following lines: “Where the debtor is a natural person, some jurisdictions exclude torts of a personal nature such as defamation, injury to credit or reputation, or personal bodily injury. The debtor remains personally entitled to sue and to retain what is recovered on the basis that the incentive to vindicate wrongdoing otherwise would be diminished, but the debtor not be entitled to sue for any loss of earnings associated with those causes of action”;

(j) Addition after paragraph 181 of text along the following lines, based on paragraph 13 of document A/CN.9/550, to address the issue of making a security interest effective against a third party: “With respect to actions to make a security interest effective against third parties, some laws dealing with security interests provide specified time periods within which those security interests should be made effective against third parties, whether by registration, publicity or some other means. Where the law of a State includes such time periods, the insolvency law may recognize them, permitting security interests to be made effective against the debtor and third parties after commencement of insolvency proceedings, but within the specified time period. Where the law does not include such time periods, the stay applicable on commencement of insolvency proceedings would operate to prevent the security interest from being made effective. The question of whether such an act in insolvency would make the security interest effective against third parties should be distinguished from the question of whether or not such acts should be permitted. The effect in insolvency will depend upon the act that is required to make the interest effective. Where, for example, effectiveness requires registration, it might be permitted to occur after commencement, but where it involves, for example, the secured creditor taking possession of an asset, a different view might be taken, as such an action would reduce the assets available for the estate”;

(k) Addition of a sentence at the end of paragraph 196 to reflect changes to recommendation 33, along the following lines: “Provisional measures would also terminate when an application for commencement is denied or the order for provisional measures is successfully challenged”;

(l) Deletion of the words “such as the date of commencement, with provision for ongoing review” at the end of the second sentence of paragraph 213 and the addition of text to address valuation of assets, along the following lines: “having regard to the purpose for which the valuation is required. In some cases assets may have been valued by the parties before commencement of the proceedings and that valuation may still be valid at commencement. There may be a need for an overall valuation shortly after commencement for the purpose of registering all assets and liabilities and preparing a net balance of the debtor’s position, so that the insolvency representative will have some idea of the value of the estate. Assets, in particular encumbered assets, may need to be valued in the course of proceedings to determine the value of the secured claim (and any related unsecured claim) and issues of protection. Assets may also need to be valued in support of the disposition of segments of the business or of specific assets other than in the ordinary course of business, and at confirmation to satisfy applicable

requirements. A related issue is the cost of valuation and the party that should bear that cost” and deletion of the last sentence of paragraph 213;

(m) Addition after the first sentence of paragraph 225, to reflect changes to recommendations 41 and 117, paragraph (b), of a sentence along the following lines: “Where a creditor committee is formed and the insolvency law provides for creditors to be consulted on the sale of assets outside the ordinary course of business, a requirement to notify creditors of any proposed sale might be satisfied by notifying the creditor committee, in order to minimize costs and avoid any delay associated with notifying all creditors”;

(n) To reflect the substance of recommendation 65, the addition of a sentence before the last sentence of paragraph 276, along the following lines: “An insolvency law should clearly address those circumstances in which the debtor is required to cure a default in order for the contract to be continued”;

(o) To reflect changes to recommendation 66, addition of a sentence along the following lines, after the second sentence of paragraph 278: “Where a contract continues to be performed prior to a determination to continue or reject that contract, the costs of continued performance arising under the contract should be payable as an administrative expense” and, at the end of the paragraph, a further sentence along the following lines: “If the insolvency representative uses third party-owned assets that are in the possession of the debtor subject to contract, the costs under the contract of continued performance of the contract should be payable as an administrative expense, and the third party should be protected against diminution of the value of those assets, to the extent that that is not covered by the contract”;

(p) Addition, in paragraph 314, of an example to explain that the reference to “potential creditors” is to parties that were not creditors at the time the avoidable transaction took place, but who were about to become creditors, such as where the debtor was negotiating new lending and transferred assets to avoid their becoming subject to a security interest;

(q) Deletion, from the first sentence of paragraph 316, of the words from “and generally” to the end of the sentence, to reflect the changes adopted with respect to recommendation 73;

(r) Addition of a sentence at the end of paragraph 341 on timing of commencement of avoidance, along the following lines: “Whichever approach is adopted, it is desirable that the time period be relatively short, as in the examples noted above, to avoid uncertainty and ensure that the insolvency proceedings proceed expeditiously”;

(s) Addition of the following words at the end of the first sentence of paragraph 343 to reflect the “ordinary course” defence in recommendation 82: “and, for example, was a transaction in the ordinary course of business”;

(t) Addition, in the first sentence of paragraph 387, of the words “concerning the debtor” to reflect changes to recommendation 96, as well as a reference to “professional secrets or privileged or otherwise confidential information”;

(u) Revision of the opening words of paragraph 408 (xv), to reflect the revision of recommendation 104, along the following lines: “continuing operation and management of the business”;

(v) Addition of a sentence at the end of paragraph 451, to reflect the discussion on recommendation 112, along the following lines: “Where the insolvency law provides for such a meeting to be convened, it is desirable that it also specify the matters to be discussed and resolved at that meeting”;

(w) Addition before the last sentence of paragraph 466, to align it with recommendations 117, paragraph (b) and 41 and paragraph 225, of text along the following lines: “The creditor committee may also have a role with respect to receiving notice on behalf of creditors of certain issues of interest to the creditors it represents. For example, where the insolvency law provides that creditors should be consulted on the sale of assets outside the ordinary course of business, notice of any such proposed sale may be provided through the creditor committee to save time, minimize costs and facilitate consultation between the committee and the creditors it represents”;

(x) To reflect the changes made to recommendation 129, the addition of the words “a summary of the plan” and “non-financial information that might have an impact on the future performance of the debtor, such as the availability of a new patent” to the second sentence of paragraph 505;

(y) Revision of the second and third sentences of paragraph 547 along the following lines: “As already discussed, this approach may not resolve the financial difficulties of the debtor, depending upon the state of implementation of the plan when it fails, and could lead to a race for assets that the commencement of collective proceedings was intended to avoid. There may be situations, however, where the appropriate course of action is to permit the court to close proceedings and allow parties in interest to exercise their rights at law. An example might be where the remaining assets are secured and there will be no distribution to unsecured creditors. In some circumstances and depending upon the state of implementation of the plan, a compromise approach may be to allow ...”;

(z) Revision of paragraph 557 to align it with the changes made to recommendations 146 and 146A, along the following lines: “It is desirable that expedited reorganization proceedings be available on the application of a debtor that is not yet eligible to commence proceedings under the general reorganization provisions of an insolvency law, but is likely to be generally unable to pay its debts in the future as they mature. Including provisions in an insolvency law that permit such debtors to commence expedited proceedings recognizes the need to address financial difficulty at an early stage and allows advantage to be taken of a voluntary restructuring agreement that the majority of affected creditors has approved. Commencing expedited proceedings will ensure the protection of dissenting creditors under the insolvency law. Jurisdictional requirements relevant to applications for insolvency proceedings generally would also apply”;

(aa) Addition at the beginning of paragraph 558 of a sentence along the following lines: “An insolvency law may also provide that expedited proceedings are available to a debtor that is already eligible to commence full proceedings under the insolvency law (see chapter I.B).”;



(bb) With respect to paragraphs 559-565, the addition (as appropriate) of text to address the content of recommendations 149, paragraph (b), 150, 152 and 153 concerning the effects of commencement of expedited proceedings and the circumstances where it will be appropriate for the court to broaden the classes of creditors affected; notification of commencement of expedited proceedings; the effect of a confirmed plan; and the failure of implementation. That text would draw upon the material addressing the same issues in chapter IV;

(cc) To address the issue of non-monetary claims, addition after the second sentence of paragraph 571 of a sentence along the following lines: “An insolvency law may also need to address the treatment of claims of a non-monetary nature, such as a right to performance of an obligation (e.g. delivery of specific property) or a non-recourse loan”;

(dd) In paragraph 594, to reflect the revision of recommendation 162, addition of the following text: (i) “or require special treatment, such as where they are claims by related persons” at the end of the second sentence; (ii) “or subjected to special treatment” in the third sentence; and (iii) “and facilitate review by the court where the insolvency representative’s decision is contested” at the end of the fourth sentence;

(ee) Revision of the third last sentence of paragraph 669 to reflect the changes made to recommendations 145A and 153, along the following lines: “Where the reorganization plan is not fully implemented, the insolvency law may provide that where there is a substantial breach of the plan by the debtor or the plan cannot be implemented, the insolvency law may provide for the court to convert the proceedings to liquidation, in order to avoid leaving the debtor in an insolvent state with its financial situation unresolved. Alternatively, the insolvency law may provide for dismissal of the proceedings in appropriate circumstances. These might include where the remaining assets are secured and there will be no distribution to unsecured creditors. Whether conversion constitutes a formal conclusion of the reorganization proceedings ...”;

(ff) Addition of a sentence on applicable law in insolvency proceedings at the end of paragraph 652, “Labour contracts”, contained in document A/CN.9/WG.V/WP.72, along the following lines: “In some States, such protections will apply only to individual employment contracts, while in others, these provisions also will apply to collective bargaining agreements”.

51. The Commission approved the inclusion of the UNCITRAL Model Law on Cross-Border Insolvency<sup>2</sup> and the Guide to Enactment<sup>3</sup> as an annex to the draft guide and noted that, since paragraphs 18, 19, 31, 72, 74 and 75 of the Guide to Enactment referred to the Convention on Insolvency Proceedings of the European Union, it would need to be amended to take account of the entry into force of Council regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings.

52. The Commission also noted that references to the discussion of relevant issues in the commentary were to be added to the recommendation section and that

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<sup>2</sup> *Official Records of the General Assembly, Fifty-second Session, Supplement No. 17 (A/52/17)*, annex I.

<sup>3</sup> A/CN.9/442, annex.

relevant recommendations might also be referred to at appropriate points in the commentary.

53. The Commission requested the Secretariat to edit and finalize the text of the guide in the light of the Commission's deliberations, undertaking any further revisions required to align the commentary of the draft with the recommendations.

54. The Commission heard a statement from the observer for the International Monetary Fund (IMF), recognizing the broad participation of the international community and the resulting high quality of the draft text and looking forward to it serving as a key tool in informing effective insolvency law internationally. Reference was made to the agreement reached between IMF, the World Bank and UNCITRAL on the basis of the proposal set forth in paragraph 21 of document A/CN.9/551. It was noted that in the next few months the World Bank would finalize the revision of its Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, that those Principles would then be combined with the draft guide and some additional work on institutional and regulatory frameworks to form a unified document, which would be presented to the Executive Boards of IMF and the Bank in October 2004. Endorsement by the Boards would allow the unified standard to be used in the assessment of countries' insolvency systems.

55. At its 792nd meeting, on 25 June, the Commission adopted the following decision:

*The United Nations Commission on International Trade Law,*

*Recognizing* the importance to all countries of strong insolvency regimes,

*Recognizing also* that it is demonstrably in the public interest to have an effective and efficient insolvency regime as a means of encouraging economic development and investment,

*Noting* the growing realization that reorganization regimes are critical to corporate and economic recovery, the development of entrepreneurial activity, the preservation of employment and the availability of venture capital,

*Noting also* that the effectiveness of reorganization regimes affects the availability of finance in the capital market, with comparative analysis of such systems becoming both common and essential for lending purposes, which affects countries at all levels of economic development,

*Noting further* the importance of social policy issues, including the interests of stakeholders in an insolvent debtor, to the design of an insolvency regime,

*Recognizing* that solutions to the key economic, legal and legislative issues raised by insolvency that are negotiated internationally through a process involving a broad range of constituents will be useful both to States that do not have an effective and efficient insolvency regime and to States that are undertaking a process of review and modernization of their insolvency regimes,

*Noting* that the UNCITRAL legislative guide on insolvency law (to which the UNCITRAL Model Law on Cross-Border Insolvency<sup>2</sup> and Guide to Enactment<sup>3</sup> are annexed) and an UNCITRAL legislative guide on secured transactions, which is currently under preparation in Working Group VI (Security Interests), together will form key elements of a modern commercial law framework,

*Recalling* the mandate given to Working Group V (Insolvency Law) to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the benefits and detriments of such approaches and recommendations,

*Appreciating* the participation in and support for the development of the legislative guide of international intergovernmental and non-governmental organizations active in the field of insolvency law reform,

*Noting with approval* the collaboration and commitment to consistent resolution of common issues between Working Group V (Insolvency Law) and Working Group VI (Security Interests) on the treatment of secured creditors and security interests in insolvency,

*Confirming* its intention to continue coordination and cooperation with the World Bank and the International Monetary Fund to facilitate the development of a unified international standard in the area of insolvency law,

*Expressing its appreciation* to Working Group V (Insolvency Law) for its work in developing the draft UNCITRAL legislative guide on insolvency law,

1. *Adopts* the *UNCITRAL Legislative Guide on Insolvency Law*, consisting of the text contained in the working paper of Working Group V (Insolvency),<sup>4</sup> as amended in the note by the Secretariat of 30 April 2004,<sup>5</sup> with the amendments adopted by the Commission at its thirty-seventh session,<sup>6</sup> and of the UNCITRAL Model Law on Cross-Border Insolvency<sup>2</sup> and Guide to Enactment<sup>3</sup> annexed thereto, and authorizes the Secretariat to edit and finalize the text of the *Legislative Guide* in the light of the deliberations of the Commission;

2. *Requests* the Secretary-General to transmit the text of the *Legislative Guide* to Governments and other interested bodies;

3. *Recommends* that all States utilize the *Legislative Guide* to assess the economic efficiency of their insolvency law regimes and give favourable consideration to the *Legislative Guide* when revising or adopting legislation relevant to insolvency, and invites States that have used the *Legislative Guide* to advise the Commission accordingly;

4. *Recommends also* that all States continue to consider implementation of the UNCITRAL Model Law on Cross-Border Insolvency.

#### **IV. Arbitration: progress report of Working Group II**

56. At its thirty-second session, in 1999, the Commission, having exchanged views on its future work in the area of international commercial arbitration, decided

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<sup>4</sup> A/CN.9/WG.V/WP.70 (Parts I and II).

<sup>5</sup> A/CN.9/559 and Add.1-3.

<sup>6</sup> *Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17)*, paras. 12-53.

to entrust that work to one of its working groups. It agreed that the priority items for consideration by the working group should be, inter alia, requirement of written form for the arbitration agreement and enforceability of interim measures of protection.<sup>7</sup> The working group, subsequently named Working Group II (Arbitration and Conciliation), commenced its work pursuant to that mandate at its thirty-second session (Vienna, 20-31 March 2000).

57. At its thirty-seventh session, the Commission took note of the progress made by the Working Group at its thirty-ninth (Vienna, 10-14 November 2003) and fortieth (New York, 23-27 February 2004) sessions (see A/CN.9/545 and A/CN.9/547, respectively). The Commission noted that the Working Group had continued its discussions on a draft text for a revision of article 17 of the UNCITRAL Model Law on International Commercial Arbitration<sup>8</sup> on the power of an arbitral tribunal to grant interim measures of protection and on a draft provision on the recognition and enforcement of interim measures of protection issued by an arbitral tribunal (for insertion as a new article of the Model Law, tentatively numbered 17 bis). The Commission commended the Working Group for the progress made so far regarding the issue of interim measures of protection.

58. The Commission was informed that the Working Group intended to complete its review of draft articles 17 and 17 bis of the Model Law, including finalizing its position on how to deal with ex parte interim measures in the Model Law, at its next two sessions (see para. 136 (b) below). The view was reiterated that the issue of ex parte interim measures, which the Commission agreed remained an important issue and a point of controversy, should not delay progress on the revision of the Model Law.<sup>9</sup> It was observed, in response, that the Working Group had not spent much time discussing the issue at its recent sessions. The hope was expressed that consensus could be reached on the issue by the Working Group at its next session, based on a revised draft to be prepared by the Secretariat.

59. The Commission also noted that the Working Group had yet to complete its work in relation to draft article 17 ter dealing with interim measures issued by state courts in support of arbitration and in relation to the “writing requirement” contained in article 7, paragraph 2, of the Model Law and article II, paragraph 2, of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the “New York Convention”).<sup>10</sup> With respect to the New York Convention, the Commission was informed that the Working Group had been invited to consider whether the Convention should be included in a list of international instruments to which the draft convention dealing with certain issues of electronic contracting currently being prepared by Working Group IV (Electronic Commerce) would apply (see also paras. 67-72).

60. With respect to future work in the field of settlement of commercial disputes, the Commission recalled that, at its previous session, it had heard proposals that

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<sup>7</sup> Ibid., *Fifty-fourth Session, Supplement No. 17 (A/54/17)*, para. 380.

<sup>8</sup> Ibid., *Fortieth Session, Supplement No. 17 (A/40/17)*, annex I.

<sup>9</sup> Ibid., *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 203.

<sup>10</sup> United Nations, *Treaty Series*, vol. 330, No. 4739.

arbitrability as well as a revision of the UNCITRAL Arbitration Rules<sup>11</sup> and the UNCITRAL Notes on Organizing Arbitral Proceedings<sup>12</sup> could be considered for inclusion in future work, once the existing projects currently being considered by the Working Group had been completed.<sup>13</sup> While the Commission was generally of the view that it would be premature to make a final decision at its current session regarding possible future work in the field of settlement of commercial disputes, some support was expressed for the Working Group to consider the possibility of undertaking a limited revision of the UNCITRAL Arbitration Rules. In that respect, the view was expressed that particular caution should be exercised in determining the scope of such a revision, which should be precisely defined in order to avoid undermining the stability of the reference offered by the UNCITRAL Arbitration Rules over the almost 30 years of existence of that instrument. The view was also expressed that preliminary consideration of a possible revision of the Rules should not prevent the Working Group from envisaging other possible topics for future work, such as the use of arbitration in corporate governance or the use of online dispute resolution mechanisms.

61. The Commission noted that 2005 would mark the twentieth anniversary of adoption of the Model Law and agreed that conferences to celebrate that anniversary should be organized in different regions to provide a forum for considering the experience of courts and arbitral tribunals with domestic enactments of the Model Law, as well as for considering possible future work in the field of settlement of commercial disputes.

## V. Transport law: progress report of Working Group III

62. At its thirty-fourth session, in 2001, the Commission established Working Group III (Transport Law) to prepare, in close cooperation with interested international organizations, a legislative instrument on issues relating to the international carriage of goods by sea, such as the scope of application, the period of responsibility of the carrier, the obligations of the carrier, the liability of the carrier, the obligations of the shipper and transport documents.<sup>14</sup> At its thirty-fifth session, in 2002, the Commission approved the working assumption that the draft instrument on transport law should cover door-to-door transport operations, subject to further consideration of the scope of application of the draft instrument after the Working Group had considered the substantive provisions of the draft instrument and come to a more complete understanding of their functioning in a door-to-door context.<sup>15</sup> At its thirty-sixth session, in 2003, the Commission noted the complexities involved in the preparation of the draft instrument and authorized the Working Group, on an exceptional basis, to hold its twelfth and thirteenth

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<sup>11</sup> *Official Records of the General Assembly, Thirty-first Session, Supplement No. 17 (A/31/17)*, para. 57.

<sup>12</sup> *UNCITRAL Yearbook*, vol. XXVII: 1996, part three, annex II.

<sup>13</sup> *Official Records of the General Assembly, Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 204.

<sup>14</sup> *Ibid.*, *Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr. 3), para. 345.

<sup>15</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, para. 224.

sessions on the basis of two-week sessions, with the agreement that the length of the Working Group's sessions would be reassessed at the thirty-seventh session of the Commission, in 2004.<sup>16</sup> For the consideration of the matter at the Commission's thirty-seventh session, see paragraphs 132 and 133 below.

63. At its thirty-seventh session, the Commission took note of the reports of the twelfth (Vienna, 6-17 October 2003) and thirteenth (New York, 3-14 May 2004) sessions of the Working Group (A/CN.9/544 and A/CN.9/552, respectively).

64. The Commission noted with appreciation that the Working Group had continued its consideration of the draft instrument on the carriage of goods [wholly or partly] [by sea]. The Commission reaffirmed its appreciation of the magnitude of the project and of the complexities involved in the preparation of the draft instrument, given in particular the controversial issues that remained open for discussion and that required the striking of a delicate balance between the various conflicting interests at stake.

65. The Commission was informed that, at its twelfth and thirteenth sessions, the Working Group had proceeded with its second reading of the draft instrument and had made progress regarding a number of difficult issues, such as those regarding the scope of application of the instrument and of key liability provisions. The Commission was also informed that, with a view to accelerating the exchange of views, the formulation of proposals and the emergence of consensus in preparation for a third and final reading of the draft instrument, a number of delegations participating in the thirteenth session of the Working Group had taken the initiative of creating an informal consultation group for the continuation of discussion between sessions of the Group.

66. The Commission expressed its support for the efforts of the Working Group to accelerate the progress of its work on the complex project. With respect to a possible time frame for completion of the draft instrument, a number of speakers were of the view that it would be desirable to complete a third reading of the draft text with a view to its adoption by the Commission in 2006. However, it was also felt by a number of speakers that achieving a high degree of quality should be a paramount objective in the preparation of the draft instrument. That objective should not be compromised by hasty deliberation of the important issues that remained to be solved. After discussion, the Commission agreed that 2006 would be a desirable goal for completion of the project, but that the issue of establishing a deadline for such completion should be revisited at its thirty-eighth session, in 2005. (For the next two sessions of the Working Group, see paragraph 136 (c) below.)

## **VI. Electronic commerce: progress report of Working Group IV**

67. At its thirty-fourth session, in 2001, the Commission endorsed a set of recommendations for future work that had been made by Working Group IV (Electronic Commerce) at its thirty-eighth session (New York, 12-23 March 2001).<sup>17</sup>

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<sup>16</sup> *Ibid.*, *Fifty-eighth Session, Supplement No. 17* (A/58/17), para. 208.

<sup>17</sup> *Ibid.*, *Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3),

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68. At its thirty-seventh session, the Commission took note of the reports of the Working Group on the work of its forty-second (Vienna, 17-21 November 2003) and forty-third (New York, 15-19 March 2004) sessions (A/CN.9/546 and A/CN.9/548, respectively).

69. The Commission noted with appreciation that the Working Group had continued its consideration of a preliminary draft convention dealing with selected issues of electronic contracting and reaffirmed its belief that an international instrument dealing with certain issues of electronic contracting would be a useful contribution that would facilitate the use of modern means of communication in cross-border commercial transactions.

70. The Commission was informed that the Working Group had undertaken a review of articles 8-15 of the revised text of the preliminary draft convention at its forty-second session. The Commission noted that the Working Group, at its forty-third session, had reviewed articles X and Y as well as articles 1-4 of the draft convention and that the Working Group had held a general discussion on draft articles 5-7 bis.

71. The Commission expressed its support for the efforts by the Working Group to incorporate in the draft convention provisions aimed at removing possible legal obstacles to electronic commerce that might arise under existing international trade-related instruments. The Commission was informed that the Working Group had agreed that it should endeavour to complete its work on the draft convention with a view to enabling its review and approval by the Commission in 2005. The Commission expressed its appreciation for the Working Group's endeavours and agreed that a timely completion of the Group's deliberations on the draft convention should be treated as a matter of importance, which would justify the approval of a forty-fourth session of the Working Group of two weeks' duration, to be held in October 2004 (see paras. 134 and 136 (d) below).

72. Views were exchanged regarding possible future work in the field of electronic commerce after completion of the current project. While it was generally agreed that no decision could be made in that respect at that stage, the Commission took note of various suggestions. One suggestion was that the Working Group should consider the preparation of guidelines to assist States with the establishment of a comprehensive legal framework to facilitate the use of electronic commerce. Possible elements of such guidelines could include data protection issues, intellectual property rights and electronic fraud issues. Another suggestion was that the Working Group might re-examine the issue of negotiability and transfer of rights in tangible or intangible goods by electronic means. Yet another suggestion was that the Working Group might need to consider its future role in the light of the conclusions to be reached in 2005 by the World Summit on the Information Society, convened by the United Nations and the International Telecommunication Union. One more suggestion noted was that the Working Group could serve as an instrument of cooperation with other working groups and with bodies outside UNCITRAL. The Secretariat was requested to consider preparing any relevant study to facilitate discussion by the Commission at its thirty-eighth session, in 2005, on the issue of future work in the area of electronic commerce.

## VII. Security interests: progress report of Working Group VI

73. At its thirty-fourth session, in 2001, the Commission entrusted Working Group VI (Security Interests) with the task of developing an efficient legal regime for security rights in goods involved in a commercial activity, including inventory.<sup>18</sup> At its thirty-fifth session, in 2002, the Commission confirmed the mandate given to the Working Group and that the mandate should be interpreted widely to ensure an appropriately flexible work product, which should take the form of a legislative guide.<sup>19</sup> At its thirty-sixth session, in 2003, the Commission confirmed that it was up to the Working Group to consider the exact scope of its work and, in particular, whether trade receivables, letters of credit, deposit accounts and intellectual and industrial property rights should be covered in the draft legislative guide.<sup>20</sup>

74. At its thirty-seventh session, the Commission had before it the reports of Working Group VI on the work of its fourth (Vienna, 8-12 September 2003) and fifth (New York, 22-25 March 2004) sessions (A/CN.9/543 and A/CN.9/549, respectively). The Commission also had before it the report of the second joint session of Working Groups V (Insolvency Law) and VI (A/CN.9/550).

75. The Commission commended Working Group VI for having completed the second reading of the draft guide on secured transactions, including the introduction and the chapters on key objectives (A/CN.9/WG.VI/WP.6/Add.1) and creation (A/CN.9/WG.VI/WP.6/Add.3), as well as the third reading of the chapter on publicity (A/CN.9/WG.VI/WP.9/Add.2), priority (A/CN.9/WG.VI/WP.9/Add.3), insolvency (A/CN.9/WG.VI/WP.9/Add.6) and conflict of laws (A/CN.9/WG.VI/WP.9/Add.7). In that connection, the Commission noted with interest that, at its fifth session, the Working Group had agreed that publicity should be a precondition of the effectiveness of security rights against third parties and of ensuring the protection of third parties (A/CN.9/549, para. 35). The Commission also expressed its appreciation to Working Groups V and VI for the progress made during their second joint session, at which they had considered pending issues of common interest (see A/CN.9/WG.V/WP.71).

76. In addition, the Commission noted with appreciation the progress made by the Working Group in the coordination of its work on conflict of laws with the Hague Conference on Private International Law and in particular the plans for a joint meeting of experts. The Commission also commended the efforts to coordinate with the International Institute for the Unification of Private Law (Unidroit), which was preparing a text on security interests in securities. The Commission also expressed its appreciation for the coordination with the World Bank, which was preparing principles and guidelines for effective insolvency and creditor rights systems, and in particular for the agreement that the World Bank text would form with the draft legislative guide on secured transactions a single international standard.

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<sup>18</sup> *Ibid.*, para. 358.

<sup>19</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, para. 204.

<sup>20</sup> *Ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 222.



77. Moreover, the Commission noted with interest that a preliminary consolidated set of recommendations might be ready by early 2005. The Commission also welcomed the preparation of additional chapters on various types of asset, such as negotiable instruments, deposit accounts, letters of credit and intellectual property rights. In that connection, while the importance of those types of asset was generally recognized, it was stated that including them in the draft guide should not be at the expense of slowing down work with respect to the core assets within the scope of the draft guide (i.e. goods, including inventory, and trade receivables).

78. After discussion, the Commission confirmed the mandate given to Working Group VI at the thirty-fourth session of the Commission and subsequently confirmed at its thirty-fifth and thirty-sixth sessions (see para. 73 above). The Commission also requested the Working Group to expedite its work so as to submit the draft guide to the Commission for final adoption as soon as possible and, it is hoped, in 2006. (For the next two sessions of the Working Group, see para. 136 (f) below.)

### VIII. Possible future work in the area of public procurement

79. At its thirty-sixth session, in 2003, the Commission considered a note by the Secretariat on possible future work in the area of public procurement (A/CN.9/539 and Add.1). It was observed that the UNCITRAL Model Law on Procurement of Goods, Construction and Services<sup>21</sup> contained procedures aimed at achieving competition, transparency, fairness, economy and efficiency in the procurement process and that it had become an important international benchmark in procurement law reform. Nevertheless, it was also observed that, despite the widely recognized value of the Model Law, novel issues and practices had arisen since its adoption that might justify an effort to adjust its text.<sup>22</sup> At that session, strong support was expressed for the inclusion of procurement law in the Commission's work programme<sup>23</sup> and the Commission requested the Secretariat to prepare detailed studies on the issues identified in the note by the Secretariat (A/CN.9/539 and Add.1) and to formulate proposals on how to address them with a view to their consideration by a working group that might be convened in the third quarter of 2004.<sup>24</sup>

80. At its thirty-seventh session, the Commission had before it a note by the Secretariat (A/CN.9/553) submitted pursuant to that request containing a summary of the studies of issues that might merit consideration in a review of the Model Law; those studies had been undertaken by the Secretariat since the thirty-sixth session of the Commission, in consultation with organizations having experience and expertise in the area of public procurement, and focused on issues arising from the increased use of electronic communications in public procurement (A/CN.9/553, paras. 10-40), as well as possible additional issues (A/CN.9/553, paras. 41-82).

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<sup>21</sup> Ibid., *Forty-ninth Session, Supplement No. 17* and corrigendum (A/49/17 and Corr.1), annex I.

<sup>22</sup> Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), paras. 225-230.

<sup>23</sup> Ibid., para. 229.

<sup>24</sup> Ibid., para. 230.

81. The Commission agreed that the Model Law would benefit from being updated to reflect new practices, in particular those resulting from the use of electronic communications in public procurement, and the experience gained in the use of the Model Law as a basis for law reform. In addition to the legislative treatment of electronic communications in public procurement, the procurement of services and remedies and enforcement were mentioned as examples of issues worthy of consideration. It was also stated that it might be useful to consider simplifying the presentation of the model provisions. However, it was pointed out that in updating the Model Law care should be taken not to depart from the basic principles behind it and not to modify the provisions whose usefulness had been proven.

82. The Commission decided to entrust the drafting of proposals for the revision of the Model Law to its Working Group I (Procurement). The Working Group was given a flexible mandate to identify the issues to be addressed in its considerations and the Secretariat was requested to present to the Working Group appropriate notes further elaborating upon issues discussed in the note by the Secretariat (A/CN.9/553) in order to facilitate the considerations of the Group. (For the next two sessions of the Working Group, see para. 136 (a) below.)

## **IX. Monitoring implementation of the New York Convention**

83. The Commission recalled that, at its twenty-eighth session, in 1995, it had approved a project, undertaken jointly with Committee D of the International Bar Association, aimed at monitoring the legislative implementation of the New York Convention.<sup>25</sup> The Secretariat presented an oral progress report to the Commission, indicating that, as at 8 April 2004, there were 134 States parties to the New York Convention and that the Secretariat had received 75 replies to the questionnaire.

84. The Commission expressed its appreciation to those States parties which had provided replies since its thirty-sixth session and called on the remaining States parties to send their replies. Subject to the availability of necessary resources, the Secretariat was invited to make every effort to produce a preliminary analysis of the replies received for consideration by the Commission at its thirty-eighth session, in 2005.

## **X. Case law on UNCITRAL texts and digests of case law on the United Nations Sales Convention and other uniform texts**

### **A. Case law**

85. The Commission noted with appreciation the continuing work under the system established for the collection and dissemination of case law on UNCITRAL texts (CLOUT), consisting of the preparation of abstracts of court decisions and arbitral awards relating to UNCITRAL texts, compilation of the full texts of those decisions and awards, as well as of the preparation of research aids and analytical tools, such as thesauri and indices. As at 22 June 2004, 42 issues of CLOUT had

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<sup>25</sup> *Ibid.*, *Fiftieth Session, Supplement No. 17 (A/50/17)*, paras. 401-404.

been prepared for publication, dealing with 489 cases, relating mainly to the United Nations Convention on Contracts for the International Sale of Goods<sup>26</sup> and the UNCITRAL Model Law on International Commercial Arbitration.<sup>8</sup>

86. The Commission expressed its appreciation to the national correspondents for their work in selecting decisions and preparing case abstracts. It was widely felt that CLOUT continued to be an important aspect of the overall training and technical assistance information activities undertaken by UNCITRAL. It was also generally felt that the wide distribution of CLOUT in both paper and electronic formats, in all the six official languages of the United Nations, promoted the uniform interpretation and application of UNCITRAL texts by facilitating access to decisions and awards from other jurisdictions.

## **B. Digests of case law on the United Nations Sales Convention and other uniform texts**

87. The Commission recalled that, at its thirty-fourth session, in 2001,<sup>27</sup> it had requested the Secretariat to prepare, in cooperation with experts and national correspondents, a text in the form of an analytic digest of court and arbitral decisions identifying trends in the interpretation of the United Nations Sales Convention. The Commission was informed that a digest of case law on the Convention had been prepared pursuant to the Commission's guidelines for preparing such a digest.<sup>27</sup> Taking note of the introduction to the digest of case law on the Sales Convention (A/CN.9/562), the Commission expressed its appreciation to experts and national correspondents for their contribution to the preparation of the digest. The Commission was further informed that, pursuant to its request at its thirty-fifth session, in 2002,<sup>28</sup> the sample drafts of a digest of case law on articles 3, 14 and 34 of the Model Law had been prepared by the Secretariat (A/CN.9/563 and Add.1).

88. There was general support in the Commission for both digests, to be published in the six official languages of the United Nations, which would assist in the dissemination of information on the two texts and further promote their adoption as well as their uniform interpretation. In addition, it was said that the digests would help judges, arbitrators, practitioners, academics and government officials use the case law relating to UNCITRAL texts more efficiently. In addition, the existence of the digests would eliminate any objection or reservation that those UNCITRAL texts failed to enhance legal certainty because of the lack of sufficient experience with their application. Thus, the digest of case law on the Sales Convention would help to reduce the practice of excluding its applicability in contracts where it would otherwise apply.

89. In the context of the discussion of the sample drafts of a digest of case law on the Model Law, it was stated that digests of case law should not constitute an

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<sup>26</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567.

<sup>27</sup> *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3), para. 395.

<sup>28</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17* (A/57/17), para. 243.

independent authority indicating the interpretation to be given to individual provisions, but should rather serve as a reference tool summarizing and pointing to the decisions that had been included in the digests. In addition, it was reiterated that the digests should present court decisions and arbitral awards in an objective way without any criticism or endorsement.<sup>29</sup> It was also stated that the digest of case law on the Model Law should avoid paraphrasing and thus possibly misrepresenting provisions of the Model Law.

90. The Commission noted that 2005 would mark the twenty-fifth anniversary of the adoption of the Sales Convention and the twentieth anniversary of the adoption of the Model Law and noted with satisfaction that conferences would be organized in different regions of the world in order to celebrate those anniversaries and to consider the experience of courts and arbitral tribunals with those texts (see also para. 61 above). States were invited to consider organizing such conferences.

91. Bearing in mind those comments, the Commission expressed its satisfaction with the publication of the digest of case law on the Sales Convention and requested the Secretariat to complete the preparation of a digest of case law relating to the Model Law.

## **XI. Training and technical assistance: follow-up to the in-depth evaluation of work of the Commission's secretariat concerned with training and technical assistance**

92. The Commission had before it a note by the Secretariat (A/CN.9/560) describing the training and technical activities undertaken since its thirty-sixth session and the direction of future activities, in particular in view of the approval by the General Assembly in December 2003 of additional human resources for the secretariat of UNCITRAL (in the form of three Professional officers), which would be devoted in part to implementing its expanded functions as regards training and technical assistance. The Commission noted that recruitment action was already under way, with two positions having already been filled and the other having been advertised.

93. The Commission requested the Secretariat to prepare a work programme and timetable for implementation of the expanded technical assistance function. The Commission recommended that the Secretariat identify national and regional needs, in conjunction with national, regional and international organizations, such as the International Trade Centre, and permanent missions to the United Nations; technical legal assistance requirements in the area of international trade law reform; and opportunities for the development of joint programmes, as well as opportunities in existing programmes providing technical legal assistance in that area.

94. The Commission reiterated its appeal to all States, international organizations and other interested entities to consider making contributions to the Trust Fund for UNCITRAL Symposia, if possible in the form of multi-year contributions, so as to facilitate planning and enable the Secretariat to meet the increasing demands from

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<sup>29</sup> Ibid., *Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3), paras. 393-395.

developing countries and States with economies in transition for training and technical legislative assistance. The Commission expressed its appreciation to those States which had contributed to the fund since the thirty-sixth session, namely, France, Greece, Mexico, Singapore and Switzerland. The Commission also expressed its appreciation to organizations that had contributed to the programme by providing funds or staff or by hosting seminars.

95. The Commission appealed to the relevant bodies of the United Nations system, organizations, institutions and individuals to make voluntary contributions to the trust fund established to provide travel assistance to developing countries that are members of the Commission. The Commission noted that no contributions to the trust fund for travel assistance had been received since the thirty-sixth session, but noted with appreciation those countries which, since the inception of the fund, had contributed, namely, Austria, Cambodia, Cyprus, Kenya, Mexico and Singapore.

96. It was noted that, since the thirty-sixth session of the Commission, seminars and briefing missions had been organized by the Secretariat (see A/CN.9/560, para. 19). In addition, it was noted that members of the Secretariat had participated as speakers at a number of meetings convened by other organizations and also that a number of requests had been turned down for lack of resources.

## **XII. Status and promotion of UNCITRAL legal texts**

97. The Commission considered the status of the conventions and model laws emanating from its work, as well as the status of the New York Convention, on the basis of a note by the Secretariat (A/CN.9/561). The Commission noted with pleasure the new actions of States and jurisdictions subsequent to the closure of its last session, on 11 July 2003, regarding the following instruments:

(a) Convention on the Limitation Period in the International Sale of Goods (New York, 1974), as amended by the Protocol of 11 April 1980.<sup>30</sup> New action by Paraguay; number of States parties: 18;

(b) [Unamended] Convention on the Limitation Period in the International Sale of Goods (New York, 1974).<sup>31</sup> New action by Paraguay; number of States parties: 25;

(c) United Nations Convention on Contracts for the International Sale of Goods (Vienna, 1980). New action by the Republic of Korea; number of States parties: 63;

(d) Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958). New action by Nicaragua; number of States parties: 134;

(e) UNCITRAL Model Law on International Commercial Arbitration (1985). New jurisdictions that have enacted legislation based on the Model Law: Bangladesh, Japan, Spain and Thailand;

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<sup>30</sup> United Nations, *Treaty Series*, vol. 1511, No. 26121.

<sup>31</sup> *Ibid.*, No. 26119.

(f) UNCITRAL Model Law on Procurement of Goods, Construction and Services (1994). New jurisdictions that have enacted legislation based on the Model Law: Slovakia;

(g) UNCITRAL Model Law on Electronic Commerce (1996).<sup>32</sup> New jurisdictions that had enacted legislation based on the Model Law: Dominican Republic; Mauritius; Panama; South Africa; the overseas territory of the United Kingdom of Great Britain and Northern Ireland, the Cayman Islands; and, within the United States of America, the State of Massachusetts;

(h) UNCITRAL Model Law on Cross-Border Insolvency (1997). New jurisdictions that had enacted legislation based on the Model Law: Poland and Romania;

(i) UNCITRAL Model Law on Electronic Signatures (2001).<sup>33</sup> New jurisdictions that had enacted legislation based on the Model Law: Mexico;

(j) UNCITRAL Model Law on International Commercial Conciliation (2002).<sup>34</sup> New jurisdictions that had enacted legislation based on the Model Law: Croatia. The Uniform Mediation Act, which was prepared by the National Conference of Commissioners on Uniform State Laws in the United States and was recommended to the states of the United States, was also based on the Model Law.

98. The Commission requested States that had enacted or were about to enact legislation based on a model law prepared by the Commission or that were considering legislative action regarding a convention resulting from the work of the Commission to inform the secretariat of the Commission accordingly. In that connection, the Commission was informed that its secretariat would include copies of national enactments on the UNCITRAL web site, in the original language and, where available, in a translation, even if unofficial, into one or more of the official languages of the United Nations. Making available national enactments of UNCITRAL instruments was said to be useful to other States in their consideration of similar legislative action. Member States were requested to assist the secretariat in obtaining the necessary authorization to publish legislation on the UNCITRAL web site in cases where specific texts or legislation databases were subject to copyright protection.

99. The Commission noted that, in order to be complete and produce practical results, efforts towards the unification and harmonization of trade law needed to result in the adoption and uniform application by States of texts prepared by the Commission. To achieve that result, the Commission requested its secretariat to increase its efforts aimed at assisting States in considering texts prepared by the Commission for adoption. The Commission appealed to the representatives and observers attending the meetings of the Commission and its working groups to contribute, to the extent they deemed appropriate, to facilitating consideration of texts of the Commission by legislative organs of their States.

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<sup>32</sup> *Official Records of the General Assembly, Fifty-first Session, Supplement No. 17 (A/51/17), annex I.*

<sup>33</sup> *Ibid., Fifty-sixth Session, Supplement No. 17 (A/56/17), annex II.*

<sup>34</sup> *Ibid., Fifty-seventh Session, Supplement No. 17 (A/57/17), annex I.*

### **XIII. Relevant General Assembly resolutions**

#### **A. Resolutions 58/75 and 58/76**

100. The Commission took note with appreciation of General Assembly resolutions 58/75, on the report of the Commission on the work of its thirty-sixth session, and 58/76, on the Model Legislative Provisions on Privately Financed Infrastructure Projects, both of 9 December 2003.

#### **B. Resolution 58/270**

101. The Commission also took note with appreciation of General Assembly resolution 58/270 of 23 December 2003, entitled “Questions relating to the proposed programme budget for the biennium 2004-2005”, in annex III of which the General Assembly decided to approve the following new posts in the Commission’s secretariat to be funded from the regular budget for the biennium 2004-2005: 1 D-2, 1 P-5 and 1 P-2. In that connection, the Commission recalled its deliberations at its thirty-fifth and thirty-sixth sessions regarding the strengthening of its secretariat.<sup>35, 36</sup>

102. The Commission was informed that two new posts had already been filled, one by a lateral transfer from New York, and that the third post was currently being advertised with a view to completing the recruitment process as soon as possible. As a result of the expansion of the Commission’s secretariat, it had been upgraded from a branch to a division within the Office of Legal Affairs—the International Trade Law Division. The Commission noted that the Division was in a process of restructuring: in particular, two pillars, of which the Commission had been informed at its thirty-sixth session,<sup>37</sup> were being established, one dealing primarily with uniform legislation and the other focusing on technical assistance coordination and external affairs.

### **XIV. Coordination and cooperation: follow-up to the in-depth evaluation of work of the Commission’s secretariat concerned with coordination and cooperation**

#### **A. Coordination of work in the area of security interests**

103. The Commission had before it a note by the Secretariat entitled “Coordination of work: activities of international organizations in the area of security interests” (A/CN.9/565). The Commission noted with appreciation the coordination efforts undertaken by its secretariat and agreed that increased efforts were necessary to

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<sup>35</sup> Ibid., *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, paras. 258-271.

<sup>36</sup> Ibid., *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, paras. 256-261.

<sup>37</sup> Ibid., paras. 257 and 258.

ensure that comprehensive and consistent advice be given to States by all organizations involved in the area of security interests law.

104. The Commission noted in particular efforts of the European Commission towards a new community instrument in which the issue of the law applicable to third-party effects of assignments, which had been settled in article 22 of the United Nations Convention on the Assignment of Receivables in International Trade (General Assembly resolution 56/81, annex) by reference to the law of the State in which the assignor was located, would be addressed. In that connection, the Commission noted with appreciation that initial contacts between its secretariat and representatives of the European Commission had indicated a willingness to address the matter in a coordinated way that would be consistent with the Assignment Convention.

105. It was widely felt that the rule in article 22 of the Assignment Convention provided certainty for third parties and thus would most likely increase the availability and reduce the cost of credit and that adoption of a different rule by the European Union would not only have a negative impact on the availability and the cost of credit but would also produce disharmony in trade relationships involving parties located within and outside the European Union, as well as European Union parties where a priority dispute was brought before a court in a non-European Union country.

106. A number of States, including States members of the European Union, indicated that they were considering ratifying or acceding to the Assignment Convention and that, as a result, had a great interest in seeing the Union adopt an approach to the issue of the law applicable to third-party effects of assignments that would be consistent with the approach followed in article 22 of the Assignment Convention. In the discussion, strong support was expressed for holding a coordination meeting that would involve representatives of the European Commission, UNCITRAL and relevant industry to resolve the matter as soon as possible so as to remove any obstacle to wide adoption of the Assignment Convention.

107. After discussion, the Commission recommended that every effort be made to avoid a future European Union instrument taking a different approach from article 22 of the Assignment Convention and requested the Secretariat to organize a meeting with representatives of the European Commission, Member States of the United Nations and industry with a view to resolving the matter as soon as possible.

## **B. International colloquium on commercial fraud**

108. At its thirty-fifth session, the Commission had considered a proposal that the Secretariat prepare a study of fraudulent financial and trade practices in various areas of trade and finance for consideration at a future session of the Commission. At that session, the Commission had been informed that fraudulent practices, which were often international in character, had a significant adverse economic impact on world trade and negatively affected legitimate devices used in world trade. It was



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noted that the incidence of such fraud was growing, in particular since the advent of the Internet had offered additional avenues to the perpetrators.<sup>38</sup>

109. At its thirty-sixth session, the Commission had considered a note by the Secretariat on possible future work relating to commercial fraud (A/CN.9/540). The Commission had been informed at that session that one of the major problems in attempting to combat commercial fraud in an effective manner was the difficulty of bringing together the appropriate public and private bodies necessary to do so and support had been expressed for the recommendation made by the Secretariat that an international colloquium be organized to address various aspects of the problem of commercial fraud from the point of view of private law and to permit an exchange of views from various interested parties, including those working in national Governments, intergovernmental organizations and relevant private organizations with a particular interest and expertise in combating commercial fraud.<sup>39</sup>

110. At its thirty-seventh session, the Commission had before it a note by the Secretariat containing a report on the Colloquium on International Commercial Fraud (A/CN.9/555), held in Vienna from 14 to 16 April 2004. The Commission expressed its appreciation for the note and the suggestions for future work contained in it (A/CN.9/555, paras. 62-71). It heard statements to the effect that the rising incidence of commercial fraud posed a considerable and growing obstacle to the growth of international trade.

111. As to the work that might be done in that area in the future, the Commission was in agreement that it would be useful if, wherever appropriate, examples of commercial fraud were to be discussed in the particular contexts of projects worked on by the Commission so as to enable delegates involved in those projects to take the problem of fraud into account in their deliberations. The Secretariat was requested to facilitate such discussions where it seemed appropriate.

112. In addition, noting that education and training played a significant part in the prevention of fraud, the Commission noted with interest suggestions according to which the Secretariat should consider preparing, in close consultation with experts, including those who had been involved in the preparation of the Colloquium, lists of common features present in typical fraudulent schemes. Such lists, accompanied by comments, could be useful as educational material for participants in international trade and other potential targets of fraudsters to the extent they would help them protect themselves and avoid becoming victims of fraudulent schemes. National and international organizations interested in fighting commercial fraud could be invited to circulate such material among their members, an exercise that could help test and improve those lists. While it was not proposed that the Commission itself or its intergovernmental working groups be directly involved in that activity, the Secretariat would keep the Commission informed about it.

### **C. Implementation of General Assembly resolution 58/75 and the report of the Office of Internal Oversight Services**

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<sup>38</sup> Ibid., *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, paras. 279-290.

<sup>39</sup> Ibid., *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, paras. 238 and 240.

113. The Commission took note of the provisions of General Assembly resolution 58/75 related to the Commission's coordination role, and the report of the Office of Internal Oversight Services on the in-depth evaluation of legal affairs,<sup>40</sup> in particular recommendation 13, entitled "Increased coordination with trade law organizations", which read as follows:

"To enhance coordination in accordance with its basic mandate and ensure a concerted approach to common issues, the International Trade Law Branch (ITLB) should meet annually with key organizations working on trade law issues to share information and workplans."

114. There was general support for the notion that the Commission, as the core legal body in the United Nations system in the field of international trade law, should adopt a more proactive attitude, through its secretariat, in fulfilling the terms of its mandate as regards coordination of activities of international organizations active in the field of international trade law both within and outside the United Nations system. It was agreed that such coordination might include the establishment of regular patterns of communication with intergovernmental organizations. It was also agreed that the Commission should work, where appropriate, with international non-governmental organizations that were formulating rules governing international trade. The exercise by the Commission of an increased role in the coordination of the work programme of the various organizations involved might also be envisaged. It was widely recognized that fulfilling that part of the Commission's mandate, which was dependent to a large extent on the availability of the necessary resources, should be facilitated by the recent increase in the staff of its secretariat.

115. As to the practical means of enhancing coordination referred to in recommendation 13, it was generally agreed that the idea of meeting annually with international organizations working on trade law issues should be interpreted in a flexible manner to allow for periodical exchanges of information on a sector-by-sector basis (for example, as regards procurement, online dispute resolution, transport documents, insolvency and secured transactions). It was also agreed that particular emphasis should be placed on coordination of activities between the Commission and regional organizations. In that respect, it was agreed that the Commission should seek to increase the use of its standards in efforts for the harmonization of trade law at the regional level.

## **XV. Other business**

### **A. Partnerships between the United Nations and non-state actors, in particular the private sector**

116. The Commission had before it a note by the Secretariat on recent developments throughout the United Nations system with respect to partnerships between the United Nations and non-state actors, in particular the private sector, and possible implications of those developments for the Commission's work (A/CN.9/564). The Commission agreed on the importance to the work of the

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<sup>40</sup> E/AC.51/2002/5.

Commission of actively engaging non-state actors, through their direct participation at meetings of the Commission and its intergovernmental working groups, in the work of promoting texts adopted by the Commission and in technical assistance related to UNCITRAL texts.

117. With respect to public-private partnerships, the Commission heard a statement by a representative of the Global Compact Office of the Secretariat on the origin, goals and objectives of the Global Compact and of its achievements and adherence to date. The key principles, in the areas of human rights, labour standards and the environment, which the Global Compact sought to integrate into business activities to advance good corporate citizenship were set forth in paragraph 6 of the note by the Secretariat (A/CN.9/564) and further information was available on the web site of the Global Compact ([www.unglobalcompact.org](http://www.unglobalcompact.org)). The Commission noted the relevance of the Global Compact to the work of the Commission and the potential for UNCITRAL texts to advance the goals of the Global Compact. The Commission recommended that member States and observers make information on the initiative known to private enterprises and business associations, such as chambers of commerce, in their own countries in order to promote wider adherence to and the application of its principles.

## **B. Willem C. Vis International Commercial Arbitration Moot**

118. It was noted with appreciation that the Institute of International Commercial Law at Pace University School of Law in White Plains, New York, had organized the Eleventh Willem C. Vis International Commercial Arbitration Moot in Vienna from 2 to 8 April 2004. As in previous years, the Moot had been co-sponsored by the Commission. It was noted that legal issues dealt with by the teams of students participating in the Eleventh Moot had been based on the United Nations Sales Convention, the International Arbitration Rules of the Singapore International Arbitration Centre, the UNCITRAL Model Law on International Commercial Arbitration and the New York Convention. Some 135 teams from law schools in 42 countries had participated in the Eleventh Moot. The best team in oral arguments was that of Osgoode Hall of York University, Toronto, Canada. The Commission noted that its secretariat had organized lectures relating to its work during the period in which the Moot had been held. It was widely felt that the annual Moot, with its broad international participation, presented an excellent opportunity to disseminate information about uniform law texts and for teaching international trade law. It was noted that the Twelfth Willem C. Vis International Commercial Arbitration Moot was to be held in Vienna from 18 to 24 March 2005.

## **C. UNCITRAL web site**

119. The Commission expressed its appreciation for the UNCITRAL web site ([www.uncitral.org](http://www.uncitral.org)), which contained current UNCITRAL documents and *travaux préparatoires* in the six official languages of the United Nations. It regarded the web site as an important component of the Commission's overall programme of information activities and training and technical assistance and noted that the web site was being used increasingly by delegates for efficient access to documents

needed in their work. The Commission encouraged the Secretariat to continue to bear in mind the principle of multilingualism in maintaining and upgrading the site.

#### **D. Bibliography**

120. The Commission noted with appreciation the bibliography of recent writings related to its work (A/CN.9/566). The Commission was informed that the bibliography was being updated on the UNCITRAL web site on an ongoing basis. The Commission stressed that it was important for the bibliography to be as complete as possible and, for that reason, requested Governments, academic institutions, other relevant organizations and individual authors to send copies of relevant publications to its secretariat.

#### **E. Limitation of documentation**

121. The Commission was apprised of an internal memorandum of 21 April 2004 from the Secretary-General containing drafting guidelines for reports drafted and/or compiled in the Secretariat. Under the drafting guidelines, reports (including those of intergovernmental bodies) should be “action-oriented” and limited to:

1. A brief discussion on organizational and procedural matters.
2. Recommendations, including resolutions and decisions adopted.
3. Policy recommendations emanating from multi-stakeholder dialogues and panels and roundtables rather than summaries of the meetings.
4. New developments, findings and recommendations, particularly for recurrent reports.
5. Quotations from United Nations documents only when legislative authority is cited.

Furthermore, the drafting guidelines provide that reports should not include:

1. A summary of statements made at opening and closing meetings, unless pertinent to conclusions reached.
2. Summaries of statements by individuals, a list of speakers for each item could be included instead.
3. A general summary of statements under each item.
4. Analysis of information provided unless required to support policy findings.
5. A lengthy discussion on organizational and procedural matters.
6. Repetition of already published texts or repetition of texts with only minor changes.
7. Extraneous information that does not contribute to deliberations.

Finally, according to the drafting guidelines:

1. Biennialization/triennialization and consolidation of reports are not a priori reasons to exceed page limits.
2. When the Secretary-General is not explicitly requested to reproduce *in extenso* information received from Member States, government replies should be summarized and page limits should apply.
3. Cut-off dates should be established and maintained for inclusion of information requested from Member States.
4. Specific questionnaires should be provided whenever possible to focus information provided. The questionnaires could also encourage limiting the replies to a predetermined length.
5. A list of reports requested at each session should be presented to the body concerned before closure of the session.

122. In his memorandum, the Secretary-General requested officials of the Secretariat to ensure that reports prepared under their authority, including those to be issued in the name of intergovernmental and expert bodies, were drafted in strict accordance with the drafting guidelines.

123. With respect to the notion of “page limit” referred to in the memorandum, the attention of the Commission was drawn to the report of the Secretary-General on improving the performance of the Department of General Assembly Affairs and Conference Services (A/57/289), paragraph 57 of which reads as follows:

“57. **Enforcing page limits.** As a result of reinforced instructions by the Secretary-General, the 16-page limit (7,200 words) on reports originating in the Secretariat is being applied systematically. Waivers to the rule are granted in only a limited number of cases. More attention must also be paid to the 20-page guideline (9,000 words) for reports of subsidiary bodies, special rapporteurs and the like, which account for a significant proportion of documents issued. Essentially, the 20-page limit will now serve as a guideline for all reports not falling within the 16-page limit. Since Secretariat officials often draft such reports, they will be required to strive for observance of the guideline”.

In addition, the attention of the Commission was drawn to paragraph 15 of General Assembly resolution 53/208 B of 18 December 1998, in which the Assembly stressed once again the need for compliance with existing page limits; and invited all intergovernmental bodies to consider, where appropriate, the possibility of further reducing the length of their reports from 32 to 20 pages without adversely affecting either the quality of presentation or the content of the reports.

124. The Commission appreciated the provision of background information on the drafting guidelines contained in the Secretary-General’s memorandum (see para. 121 above), which aimed to achieve the page limits for reports of subsidiary bodies as discussed above. However, the Commission recalled the particular characteristics of its work that made it inappropriate for page limits to be applied to the documentation of the Commission or its subsidiary bodies.

125. The Commission noted that it had been established by the General Assembly by its resolution 2205 (XXI) with a broad mandate to further the progressive harmonization and unification of the law of international trade and in that respect to

bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade. The Commission also recalled that, if international legal rules were to be drawn up by consensus, the building of such consensus would typically require an analysis and precise statement of existing law and commercial practice. In addition, the Commission recalled that the legal standards it prepared for consideration by States when modernizing their legislation in the field of international trade law had to be justified by evidence of existing law and the requirements of its progressive development in the light of the current needs of the international community. Thus, the draft articles or other recommendations contained in documentation prepared for the Commission or its subsidiary bodies and in the reports of the Commission and its subsidiary bodies themselves had to be supported by sufficient references to existing law, commercial practice and other relevant data, including treaties, judicial decisions and, occasionally, doctrine.

126. In addition, the Commission noted that maintaining the level of detail and high quality of its documentation was necessary for the following reasons: (a) they were a critical component in the process of consulting States and obtaining their views; (b) they assisted individual States in the understanding and interpretation of the rules embodied in legal standards prepared by the Commission; (c) they were part of the *travaux préparatoires* of such standards and were frequently referred to or quoted by national legislators, judges and lawyers applying the standards; and (d) they contributed to the dissemination of information about international trade law in accordance with the relevant United Nations programme.

127. Accordingly, the Commission considered that it would be entirely inappropriate to attempt in advance and *in abstracto* to fix the maximum length of its reports or those of its subsidiary bodies or of the various studies and other working documents presented to it or its subsidiary bodies. As explained above, the length of a given Commission document would depend on a number of variable factors, such as the nature of the topic and the extent of relevant legal practice, doctrine and precedent. The Commission considered therefore that regulations on page limits such as those contained in the report of the Secretary-General (A/57/289) should not apply to its documentation. In that respect, the Commission noted an important qualification in the Secretary-General's drafting guidelines that reports should not include "analysis of information provided unless required to support policy findings". To the extent that the reports of the Commission and its subsidiary bodies invariably contained explanations and recommendations adopted concerning texts of legal standards prepared by the Commission, such explanations and recommendations were "policy findings" and should necessarily be supported by the "analysis of information" that constituted the *travaux préparatoires*. The Commission unanimously agreed that *travaux préparatoires* were indispensable to legislative deliberations and to judicial interpretation and differed fundamentally from summaries of meetings devoted to other types of deliberation.

128. It was noted that a waiver of page limits could be granted with respect to particular documents, but that that was a time-consuming process. The Commission urged the General Assembly to reconsider the application of page limits in connection with the Commission's work. The Commission also recalled that it and its subsidiary bodies were fully conscious of the need to achieve economies whenever possible in the overall volume of documentation and would continue to bear such considerations in mind, as evidenced by the efforts made, in particular, by

its Working Group III (Transport Law), which had recently achieved a considerable reduction in the length of its report (A/CN.9/552). It was generally felt, however, that such efforts had reached the limit beyond which further reduction would considerably affect the quality of the documentation needed to reflect the implications of a particularly important and complex project.

## F. Provision of summary records

129. The Commission was informed that, in its resolution 58/250 of 23 December 2003, the General Assembly had requested the Secretary-General to review the list of bodies entitled to summary records, in full consultation with all relevant intergovernmental bodies, with a view to assessing the need for such records, and to explore the possibility of delivering them in a more efficient and effective manner. The Secretariat had therefore been requested to consult with the members of the Commission to determine whether they could consider the possibility of relinquishing or curtailing the use of summary records. The two main factors brought to the attention of the Commission on behalf of the Committee on Conferences were the limited resources available for producing those records and the consequent delay in their issuance. The Commission was informed that, under the prevailing circumstances, it was unlikely that records would be produced in a timely manner in the foreseeable future. The following possible alternatives to summary records were suggested for consideration by the Commission: (a) unedited verbatim transcripts in the original language (as currently in use by the Committee on the Peaceful Uses of Outer Space); (b) digital sound recordings of the proceedings made available in all six official languages on the United Nations web site or at specially equipped listening booths; (c) provisional issuance of summary records in the original language, with non-simultaneous issuance in the other languages at a later stage; or (d) limiting summary records to decision-making meetings (the Commission, for example, using summary records only when preparing legal instruments).

130. The Commission unanimously stressed the importance of summary records as essential elements of the *travaux préparatoires* that should be available for subsequent reference when interpreting the standards drawn up by the Commission. It was generally agreed that the issuance of summary records shortly after the related deliberations had taken place was desirable and would allow for the reproduction of those records in the *UNCITRAL Yearbook* prepared during the year following a given session of the Commission. However, it was also agreed that speed in the production of summary records was not the most important factor. Summary records would remain useful and indispensable for the full understanding of the legislative history of a given legal text even if they were issued a few years after the adoption of that text. With respect to the suggested alternatives, it was generally agreed that: (a) unedited verbatim transcripts would be of little use in view of the lack of a translation in the other official languages; (b) digital sound recordings would be even less useful in view of the lack of proper indexing, which would make the use of such recordings extremely difficult and time-consuming; (c) provisional issuance of summary records in the original language might be acceptable, provided that the other language versions would in fact be issued, albeit at a later stage; and (d) limiting the use of summary records was already consistent

with the practice followed by UNCITRAL, which made use of summary records only in the context of its deliberations for the preparation of a normative instrument.

### **G. Proposed strategic framework for the period 2006-2007**

131. The Commission's attention was drawn to subprogramme 5 (Progressive harmonization, modernization and unification of the law of international trade) of the proposed strategic framework for the period 2006-2007 (A/59/6 (Prog.6)). The Commission noted with appreciation that, in drafting the indicators of achievement for 2006-2007, the Secretariat had put into practice the lessons learned as regards the formulation of the expected accomplishments and indicators of achievement for the biennium 2002-2003. In particular, in situations where it was acceptable or unavoidable to formulate expected accomplishments in broad and unfocused terms, those had been combined with realistic and usable indicators of achievement.

## **XVI. Date and place of future meetings**

### **A. General discussion on the duration of sessions**

132. The Commission recalled that, at its thirty-sixth session, it had agreed that: (a) working groups should normally meet for a one-week session twice a year; (b) extra time, if required, could be allocated from the unused entitlement of another working group provided that such an arrangement would not result in the increase of the total number of 12 weeks of conference services per year currently allotted to sessions of all six working groups of the Commission; and (c) if any request by a working group for extra time would result in the increase of the 12-week allotment, it should be reviewed by the Commission, with proper justification being given by that working group regarding the reasons for which a change in the meeting pattern was needed.<sup>41</sup> At the same session, it had also been agreed that the situation with regard to the duration of sessions of Working Group III (Transport Law) would need to be reassessed at the thirty-seventh session of the Commission (see also para. 62).<sup>42</sup>

133. At its thirty-seventh session, for the reasons noted by the Commission at its thirty-sixth session,<sup>43</sup> the Commission decided to accommodate again the need of Working Group III (Transport Law) for two-week sessions, utilizing the entitlement of Working Group V (Insolvency Law), which was not expected to meet in the second half of 2004 or in 2005.

134. The Commission also approved the holding of a two-week session of Working Group IV (Electronic Commerce) in October 2004 in order to ensure the uninterrupted process of negotiation and drafting of the draft convention and its circulation for comments shortly after the session in October. The Commission

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<sup>41</sup> *Official Records of the General Assembly, Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 275.

<sup>42</sup> *Ibid.*, para. 208.

<sup>43</sup> *Ibid.*, para. 272.



noted that, by accelerating the work of Working Group IV, it would be possible not to hold one week of meetings of Working Group IV in late 2005.

## **B. Thirty-eighth session of the Commission**

135. The Commission approved the holding of its thirty-eighth session in Vienna from 4 to 22 July 2005. It was noted that the Commission did not intend to make full use of its four-week allotment of conference services in 2005. The duration of the session might be shortened further, should a shorter session become advisable in view of the draft texts produced by the various working groups.

## **C. Sessions of working groups up to the thirty-eighth session of the Commission**

136. The Commission approved the following schedule of meetings for its working groups:

(a) Working Group I (Procurement) would hold its sixth session in Vienna from 30 August to 3 September 2004 and its seventh session in New York from 4 to 8 April 2005;

(b) Working Group II (Arbitration) would hold its forty-first session in Vienna from 13 to 17 September 2004 and its forty-second session in New York from 10 to 14 January 2005;

(c) Working Group III (Transport Law) would hold its fourteenth session in Vienna from 29 November to 10 December 2004 and its fifteenth session in New York from 18 to 28 April 2005 (the United Nations would be closed on 29 April, Orthodox Good Friday);

(d) Working Group IV (Electronic Commerce) would hold its forty-fourth session in Vienna from 11 to 22 October 2004 and, if necessary, a forty-fifth session in New York from 11 to 15 April 2005;

(e) Working Group V (Insolvency Law). No session of the Working Group was envisaged;

(f) Working Group VI (Security Interests) would hold its sixth session in Vienna from 27 September to 1 October 2004 and its seventh session in New York from 24 to 28 January 2005.

## **D. Sessions of working groups in 2005 after the thirty-eighth session of the Commission**

137. The Commission noted that tentative arrangements had been made for working group meetings in 2005 after its thirty-eighth session (the arrangements were subject to the approval of the Commission at its thirty-eighth session):

(a) Working Group I (Procurement) would hold its eighth session in Vienna from 17 to 21 October 2005;

(b) Working Group II (Arbitration) would hold its forty-third session in Vienna from 3 to 7 October 2005;

(c) Working Group III (Transport Law) would hold its sixteenth session in Vienna from 28 November to 9 December 2005;

(d) Working Group IV (Electronic Commerce). No session of the Working Group was envisaged;

(e) Working Group V (Insolvency Law). No session of the Working Group was envisaged;

(f) Working Group VI (Security Interests) would hold its eighth session in Vienna from 5 to 9 September 2005.

#### ANNEX

The Annex to the report of UNCITRAL at its thirty-seventh session is reproduced in Part Three of the present Yearbook.

**B. United Nations Conference on Trade and Development (UNCTAD):  
extract from the report of the Trade and Development Board  
on its fifty-first session  
(TD/B/51/8 (Vol.I))**

**Progressive development of the law of international trade:  
thirty-seventh annual report of the United Nations Commission  
on International Trade Law**

At its 962<sup>nd</sup> plenary meeting, on 15 October 2004, the Board took note of the report of UNCITRAL on its thirty-seventh session (A/59/17).

**C. General Assembly: Report of the Sixth Committee on the  
report of the United Nations Commission on International Trade Law  
on the work of its thirty-seventh session (A/59/509)**

*Rapporteur:* Ms. Anna Sotaniemi (Finland)

**I. INTRODUCTION**

1. At its 2nd plenary meeting, on 17 September 2004, the General Assembly, on the recommendation of the General Committee, decided to include in the agenda of its fifty-ninth session the item entitled “Report of the United Nations Commission on International Trade Law on the work of its thirty-seventh session” and to allocate it to the Sixth Committee.
2. The Sixth Committee considered the item at its 1st, 2nd, 14th and 16th meetings, on 4, 5, 26 and 29 October 2004. The views of the representatives who spoke during the Committee’s consideration of the item are reflected in the relevant summary records (A/C.6/59/SR.1, 2, 14 and 16).
3. For its consideration of the item, the Committee had before it the report of the United Nations Commission on International Trade Law on its thirty-seventh session.<sup>1</sup>
4. At the 1st meeting, on 4 October, the Chairman of the United Nations Commission on International Trade Law at its thirty-seventh session introduced the report of the Commission on the work of that session.

**II. CONSIDERATION OF PROPOSALS**

**A. Draft resolution A/C.6/59/L.11**

5. At the 14th meeting, on 26 October, the representative of Austria, on behalf of Algeria, Argentina, Australia, Austria, Bahamas, Belarus, Belgium, Brazil, Bulgaria, Canada, Chile, China, Colombia, Croatia, Cyprus, the Czech Republic, the Democratic Republic of the Congo, Denmark, the Dominican Republic, Ecuador, El Salvador, Fiji, Finland, France, Gabon, Germany, Greece, Guatemala, Guinea, Hungary, India, Iran (Islamic Republic of), Ireland, Israel, Italy, Jordan, Liechtenstein, Lithuania, Luxembourg, Madagascar, Mexico, Mongolia, Morocco, the Netherlands, New Zealand, Norway, Paraguay, the Philippines, Portugal, the Republic of Korea, Romania, the Russian Federation, Serbia and Montenegro, Sierra Leone, Singapore, Slovakia, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Thailand, the former Yugoslav Republic of Macedonia, Trinidad and Tobago, Turkey, Uganda, the United Kingdom of Great Britain and Northern Ireland and Uruguay, subsequently joined by Kenya, Malaysia, Tunisia

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<sup>1</sup> *Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17).*

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and Ukraine, introduced a draft resolution entitled “Report of the United Nations Commission on International Trade Law on the work of its thirty-seventh session” (A/C.6/59/L.11).

6. At the 16th meeting, on 29 October, the Committee adopted draft resolution A/C.6/59/L.11 without a vote (see para. 10, draft resolution I).

7. After the adoption of the draft resolution, the representatives of the United States of America and Japan made statements in explanation of position (see A/C.6/59/SR.16).

#### **B. Draft resolution A/C.6/59/L.12**

8. At the 14th meeting, on 26 October, the Chairman of the Committee introduced a draft resolution entitled “Legislative Guide on Insolvency Law of the United Nations Commission on International Trade Law” (A/C.6/59/L.12).

9. At the 16th meeting, on 29 October, the Committee adopted draft resolution A/C.6/59/L.12 without a vote (see para. 10, draft resolution II).

### **III. RECOMMENDATIONS OF THE SIXTH COMMITTEE**

10. The Sixth Committee recommends to the General Assembly the adoption of the following draft resolutions:

[The text of the draft resolutions is not reproduced in this section. The draft resolutions were adopted, with editorial changes, as General Assembly resolutions 59/39 and 59/40 (see section D below).]

**D. General Assembly resolutions 59/39 and 59/40  
of 2 December 2004**

**Resolutions adopted by the General Assembly on the report  
of the Sixth Committee (A/59/509)**

**59/39. Report of the United Nations Commission on International Trade Law  
on the work of its thirty-seventh session**

*The General Assembly,*

*Recalling* its resolution 2205 (XXI) of 17 December 1966, by which it established the United Nations Commission on International Trade Law with a mandate to further the progressive harmonization and unification of the law of international trade and in that respect to bear in mind the interests of all peoples, in particular those of developing countries, in the extensive development of international trade,

*Reaffirming its belief* that the progressive modernization and harmonization of international trade law, in reducing or removing legal obstacles to the flow of international trade, especially those affecting the developing countries, would contribute significantly to universal economic cooperation among all States on a basis of equality, equity and common interest and to the elimination of discrimination in international trade and, thereby, to the well-being of all peoples,

*Having considered* the report of the Commission on its thirty-seventh session,<sup>1</sup>

*Reiterating its concern* that activities undertaken by other bodies in the field of international trade law without adequate coordination with the Commission might lead to undesirable duplication of efforts and would not be in keeping with the aim of promoting efficiency, consistency and coherence in the unification and harmonization of international trade law,

*Reaffirming* the mandate of the Commission, as the core legal body within the United Nations system in the field of international trade law, to coordinate legal activities in this field, in particular to avoid duplication of efforts, including among organizations formulating rules of international trade, and to promote efficiency, consistency and coherence in the modernization and harmonization of international trade law, and to continue, through its secretariat, to maintain close cooperation with other international organs and organizations, including regional organizations, active in the field of international trade law,

1. *Takes note with appreciation* of the report of the United Nations Commission on International Trade Law on its thirty-seventh session;<sup>1</sup>

2. *Commends* the Commission for the completion and adoption of its Legislative Guide on Insolvency Law;<sup>2</sup>

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<sup>1</sup> *Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17).*

<sup>2</sup> *Ibid.*, chap. III.

3. *Also commends* the Commission for the progress made in the work on a draft convention on electronic contracting, on a draft instrument on transport law, on a draft legislative guide on secured transactions and on model legislative provisions on interim measures in international commercial arbitration, and for the Commission's decision to undertake a revision of its Model Law on Procurement of Goods, Construction and Services<sup>3</sup> to reflect new practices, including those resulting from the increasing use of electronic communications in public procurement;<sup>4</sup>

4. *Endorses* the efforts and initiatives of the Commission, as the core legal body within the United Nations system in the field of international trade law, aimed at increasing coordination of and cooperation on legal activities of international and regional organizations active in the field of international trade law, and in this regard appeals to relevant international and regional organizations to coordinate their legal activities with those of the Commission, to avoid duplication of efforts and to promote efficiency, consistency and coherence in the modernization and harmonization of international trade law;

5. *Reaffirms* the importance, in particular for developing countries, of the work of the Commission concerned with training and legislative technical assistance in the field of international trade law, and in this connection:

(a) Welcomes the Commission's initiatives towards expanding, through its secretariat, its training and legislative technical assistance programme;

(b) Expresses its appreciation to the Commission for organizing seminars and briefing missions in Azerbaijan, Colombia, Serbia and Montenegro, the Sudan, Thailand, Venezuela and Yemen;

(c) Expresses its appreciation to the Governments whose contributions enabled the seminars and briefing missions to take place, and appeals to Governments, the relevant bodies of the United Nations system, organizations, institutions and individuals to make voluntary contributions to the United Nations Commission on International Trade Law Trust Fund for Symposia and, where appropriate, to the financing of special projects, and otherwise to assist the secretariat of the Commission in carrying out training and legislative technical assistance activities, in particular in developing countries;

(d) Reiterates its appeal to the United Nations Development Programme and other bodies responsible for development assistance, such as the World Bank and regional development banks, as well as to Governments in their bilateral aid programmes, to support the training and legislative technical assistance programme of the Commission and to cooperate and coordinate their activities with those of the Commission;

6. *Takes note with regret* that, since the previous session of the Commission, no contributions have been made to the trust fund established to provide travel assistance to developing countries that are members of the Commission, at their request and in consultation with the Secretary-General, stresses the need for contributions to the trust fund in order to increase expert representation from developing countries at sessions of the Commission and its working groups, and reiterates its appeal to Governments, the relevant bodies of the

<sup>3</sup> Ibid., *Forty-ninth Session, Supplement No. 17* and corrigendum (A/49/17 and Corr.1), annex I.

<sup>4</sup> Ibid., *Fifty-ninth Session, Supplement No. 17 (A/59/17)*, chap. VIII, paras. 81 and 82.

United Nations system, organizations, institutions and individuals to make voluntary contributions to the trust fund;

7. *Decides*, in order to ensure full participation by all Member States in the sessions of the Commission and its working groups, to continue, in the competent Main Committee during the fifty-ninth session of the General Assembly, its consideration of granting travel assistance to the least developed countries that are members of the Commission, at their request and in consultation with the Secretary-General;

8. *Recalls* its resolutions on partnerships between the United Nations and non-State actors, in particular the private sector,<sup>5</sup> and in this regard welcomes the Commission's consideration of the means of actively engaging non-State actors in its work,<sup>6</sup> and encourages the Commission to further explore different approaches to the use of partnerships with non-State actors in the implementation of its mandate, in particular in the area of training and technical assistance, in accordance with the applicable principles and guidelines and in cooperation and coordination with other relevant offices of the Secretariat;

9. *Approves*, in conformity with its resolutions on documentation-related matters, which, in particular, emphasize that any reduction in the length of documents should not adversely affect either the quality of the presentation or the substance of the documents,<sup>7</sup> the conclusions reached by the Commission in paragraphs 124 to 128 of its report<sup>1</sup> regarding the imposition of page limits on its documentation, and requests the Secretary-General to bear in mind the particular characteristics of the mandate and work of the Commission in implementing page limits with respect to the documentation of the Commission;

10. *Also approves* the conclusions of the Commission in paragraph 130 of its report regarding the need for the continuing provision of summary records of its meetings relating to the formulation of normative texts;

11. *Stresses* the importance of bringing into effect the conventions emanating from the work of the Commission for the global unification and harmonization of international trade law, and, to this end, urges States that have not yet done so to consider signing, ratifying or acceding to those conventions;

12. *Notes* that 2005 will mark the twenty-fifth anniversary of the adoption of the United Nations Convention on Contracts for the International Sale of Goods<sup>8</sup> and the twentieth anniversary of the adoption of the Model Law on International Commercial Arbitration of the United Nations Commission on International Trade Law,<sup>9</sup> and in this regard welcomes initiatives being undertaken to organize conferences and similar events to provide a forum for assessing the experience, in particular of courts and arbitral tribunals, with those texts;

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<sup>5</sup> Resolutions 55/215, 56/76 and 58/129.

<sup>6</sup> See *Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17)*, chap. XV, sect. A.

<sup>7</sup> Resolutions 57/283 B, section III, para. 29, and 58/250, section III, paras. 2 and 17.

<sup>8</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567.

<sup>9</sup> *Official Records of the General Assembly, Fortieth Session, Supplement No. 17 (A/40/17)*, annex I.



13. *Expresses its appreciation* for the preparation of a digest of case law on the United Nations Convention on Contracts for the International Sale of Goods, intended to assist in the dissemination of information on the Convention and promote its adoption, use and uniform interpretation, and for the progress of work on a digest of case law relating to the Model Law on International Commercial Arbitration.

*65th plenary meeting  
2 December 2004*

**59/40. Legislative Guide on Insolvency Law of the United Nations  
Commission on International Trade Law**

*The General Assembly,*

*Recognizing* the importance to all countries of strong, effective and efficient insolvency regimes as a means of encouraging economic development and investment,

*Noting* the growing realization that reorganization regimes are critical to corporate and economic recovery, the development of entrepreneurial activity, the preservation of employment and the availability of finance in the capital market,

*Noting also* the importance of social policy issues to the design of an insolvency regime,

*Noting with satisfaction* the completion and adoption of the Legislative Guide on Insolvency Law of the United Nations Commission on International Trade Law by the Commission at its thirty-seventh session, on 25 June 2004,<sup>1</sup>

*Believing* that the Legislative Guide, which includes the text of the Model Law on Cross-Border Insolvency and the Guide to Enactment recommended by the General Assembly in its resolution 52/158 of 15 December 1997, contributes significantly to the establishment of a harmonized legal framework for insolvency and will be useful both to States that do not have an effective and efficient insolvency regime and to States that are undertaking a process of review and modernization of their insolvency regimes,

*Recognizing* the need for cooperation and coordination between international organizations active in the field of insolvency law reform to ensure consistency and alignment of that work and to facilitate the development of international standards,

*Noting* that the preparation of the Legislative Guide was the subject of due deliberations and extensive consultations with Governments and international intergovernmental and non-governmental organizations active in the field of insolvency law reform,

1. *Expresses its appreciation* to the United Nations Commission on International Trade Law for the completion and adoption of its Legislative Guide on Insolvency Law;<sup>1</sup>

2. *Requests* the Secretary-General to publish the Legislative Guide and to make all efforts to ensure that it becomes generally known and available;

3. *Recommends* that all States give due consideration to the Legislative Guide when assessing the economic efficiency of their insolvency regimes and when revising or adopting legislation relevant to insolvency;

4. *Recommends also* that all States continue to consider implementation of the Model Law on Cross-Border Insolvency of the United Nations Commission on International Trade Law.

*65th plenary meeting  
2 December 2004*

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<sup>1</sup> *Official Records of the General Assembly, Fifty-ninth Session, Supplement No. 17 (A/59/17), chap. III.*

*Part Two*

**STUDIES AND REPORTS ON SPECIFIC SUBJECTS**



# I. INSOLVENCY LAW

## A. Report of the Working Group on Insolvency Law on the work of its twenty-ninth session (Vienna, 1-5 September 2003)

(A/CN.9/542) [Original: English]

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## I. Introduction: Summary of the previous deliberations of the Working Group

1. The United Nations Commission on International Trade Law (UNCITRAL), at its thirty-second session, in 1999, had before it a proposal by Australia on possible future work in the area of insolvency law (A/CN.9/462/Add.1). That proposal considered that, in view of its universal membership, its previous successful work on cross-border insolvency and its established working relations with international organizations that had expertise and interest in the law of insolvency, the Commission was an appropriate forum for the discussion of insolvency law issues. The proposal urged the Commission to consider entrusting a working group with the development of a model law on corporate insolvency to foster and encourage the adoption of effective national corporate insolvency regimes.

2. Recognition was expressed in the Commission for the importance to all countries of strong insolvency regimes. The view was expressed that the type of insolvency regime that a country had adopted had become a “front-line” factor in international credit ratings. Concern was expressed, however, about the difficulties associated with work at an international level on insolvency legislation, which involved sensitive and potentially diverging socio-political choices. In view of those difficulties, the fear was expressed that the work might not be brought to a successful conclusion. It was said that a universally acceptable model law was in all likelihood not feasible and that any work needed to take a flexible approach that would leave options and policy choices open to States. While the Commission heard expressions of support for such flexibility, it was generally agreed that the Commission could not take a final decision on committing itself to establishing a working group to develop model legislation or another text without further study of the work already being undertaken by other organizations and consideration of the relevant issues.

3. To facilitate that further study, the Commission decided to convene an exploratory session of a working group to prepare a feasibility proposal for consideration by the Commission at its thirty-third session. That exploratory session of the Working Group was held in Vienna from 6 to 17 December 1999.<sup>1</sup>

4. At its thirty-third session, in 2000, the Commission noted the recommendation that the Working Group had made in its report (A/CN.9/469, para. 140) and gave the Group the mandate to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including consideration of out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches.

5. It was agreed that in carrying out its task the Working Group should be mindful of the work under way or already completed by other organizations, including the World Bank, the International Monetary Fund (IMF), the Asian Development Bank (ADB), the International Federation of Insolvency Professionals

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<sup>1</sup> *Official Records of the General Assembly, Fifty-fourth Session, Supplement No. 17 (A/54/17)*, paras. 383-385.

(INSOL International) and Committee J of the Section on Business Law of the International Bar Association (IBA).<sup>2</sup>

6. In order to obtain the views of and to benefit from the expertise of those organizations, the Secretariat, in cooperation with INSOL and IBA, organized the UNCITRAL/INSOL/IBA Global Insolvency Colloquium in Vienna, from 4-6 December 2000.

7. At its thirty-fourth session, in 2001, the Commission had before it the report of the Colloquium (A/CN.9/495). The Commission took note of the report with satisfaction and commended the work accomplished thus far, in particular the holding of the Global Insolvency Colloquium and the efforts of coordination with the work carried out by other international organizations in the area of insolvency law. The Commission discussed the recommendations of the Colloquium, in particular with respect to the form that the future work might take and interpretation of the mandate given to the Working Group by the Commission at its thirty-third session. The Commission confirmed that the mandate should be widely interpreted to ensure an appropriately flexible work product, which should take the form of a legislative guide. In order to avoid the legislative guide being too general or too abstract to provide the required guidance, the Commission suggested that the Working Group should bear in mind the need to be as specific as possible in developing its work. To that end, model legislative provisions, even if only addressing some of the issues to be included in the guide, should be included as far as possible.<sup>3</sup>

8. The Working Group on Insolvency Law commenced consideration of this work at its twenty-fourth session (New York, 23 July-3 August 2001), with the first draft of the legislative guide on insolvency law. The report of that meeting is contained in document A/CN.9/504. Work continued at the twenty-fifth (Vienna, 3-14 December 2001), twenty-sixth (New York, 13-17 May 2002) and twenty-seventh (Vienna, 9-13 December 2002) sessions of the Working Group. The reports of those meetings are contained in documents A/CN.9/507, A/CN.9/511 and A/CN.9/529 respectively.

9. At its twenty-seventh session, in response to a request by the Commission at its thirty-fifth session, in 2002, that the Working Group make a recommendation as to the completion of its work,<sup>4</sup> the Working Group stressed the need to finalize the guide as soon as possible and recommended that, while the draft guide might not be ready for final adoption by the Commission in 2003, nevertheless a draft should be presented to the Commission in 2003 for preliminary consideration and assessment of the policies on which the legislative guide was based. Such an approach would facilitate the use of the legislative guide as a reference tool before final adoption in 2004 and would allow those countries that had not participated in the Working Group an opportunity to consider the development of the guide. It was noted that the Working Group might require a further session in the second half of 2003 and possibly even the first half of 2004 to refine the text for final adoption (A/CN.9/529, para. 17).

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<sup>2</sup> Ibid., *Fifty-sixth Session, Supplement No. 17* (A/56/17).

<sup>3</sup> Ibid., *Fifty-sixth Session, Supplement No. 17 and Corrigendum* (A/56/17 and Corr.3), paras. 296-308.

<sup>4</sup> Ibid., *Fifty-seventh Session, Supplement No. 17* (A/57/17), para. 194.



10. At its twenty-eighth session (New York, 24-28 February 2003), the Working Group adopted the following recommendation to the Commission (A/CN.9/530, para. 18):

“After five sessions (between July 2001 and February 2003) of extensive study, analysis and deliberation, the Working Group advises the Commission that it has completed its review of the core substance of the draft legislative guide on insolvency law (as set forth in document A/CN.9/WG.V/WP.63 and Add.1-17) and recommends that the Commission:

“1. Approve the scope of the work undertaken by the Working Group as being responsive to the mandate given to the Working Group to prepare ‘a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including consideration of out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches’;

“2. Give preliminary approval to the key objectives, general features and structure of insolvency regimes as set forth in the introductory chapters of part one of the legislative guide;

“3. Direct the Secretariat to make the current draft of the legislative guide available to all United Nations Member States, relevant intergovernmental and non-governmental international organizations, as well as the private sector and regional organizations for comment;

“4. Continue to work collaboratively with the World Bank and other organizations working in the field of insolvency law reform to ensure complementarity and avoid duplication and take into consideration the work of Working Group VI on secured transactions; and

“5. Direct the Working Group to complete its work on the legislative guide and present it to the Commission in 2004 for approval and adoption.”

11. At its thirty-sixth session, in 2003, the Commission considered the draft legislative guide and gave its approval in principle, subject to completion consistent with the key objectives. The Commission requested the Secretariat to make the draft legislative guide available to Member States, relevant intergovernmental and non-governmental international organizations, as well as private sector and regional organizations and individual experts, for comment as soon as possible, and to present it to the Commission in 2004 for approval and adoption.<sup>5</sup>

## II. Organization of the session

12. Working Group V (Insolvency Law), which was composed of all States members of the Commission, held its twenty-ninth session in Vienna from 1-5 September 2003. The session was attended by representatives of the following

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<sup>5</sup> For the complete text of the Commission’s decision see *Official Records of the General Assembly, Fifty-eighth Session, Supplement No. 17 (A/58/17)*, paras. 172-197.

States members of the Working Group: Austria, Canada, China, Colombia, France, Germany, Hungary, India, Italy, Japan, Lithuania, Mexico, Morocco, Singapore, Spain, Sudan, Sweden, Thailand, Uganda, United Kingdom of Great Britain and Northern Ireland and United States of America.

13. The session was attended by observers from the following States: Argentina, Australia, Costa Rica, Czech Republic, Denmark, Ireland, Lebanon, Netherlands, Nigeria, Peru, Republic of Korea, Switzerland, Turkey and Ukraine.

14. The session was also attended by observers from the following international organizations: (a) organizations of the United Nations system: International Monetary Fund and the World Bank; (b) intergovernmental organizations: Organisation for Economic Cooperation and Development; (c) non-governmental organizations: American Bar Association, American Bar Foundation, Center of Legal Competence, Groupe de réflexion sur l'insolvabilité (GRIP), International Bar Association, International Federation of Insolvency Professionals (INSOL International), International Insolvency Institute and National Law Center for Inter-American Free Trade.

15. The Working Group elected the following officers:

*Chairman:* Wisit WISITSORA-AT (Thailand)

*Vice-chairman:* Soogeun OH (Republic of Korea), elected in his personal capacity

*Rapporteur:* Jorge PINZÓN SÁNCHEZ (Colombia).

16. The Working Group had before it the following documents:

Note by the Secretariat: draft legislative guide on insolvency law (A/CN.9/WG.V/WP.63 and Add. 1-17)

Draft legislative guide on insolvency law—glossary (A/CN.9/WG.V/WP.67) and

Note by the Secretariat: draft legislative guide on insolvency law (rights of set-off and financial contracts and netting) (A/CN.9/WG.V/WP.68).

17. The following background materials were also made available:

Note by the Secretariat on possible future work on insolvency law (A/CN.9/WG.V/WP.50)

Reports of the Secretary-General on the draft legislative guide on insolvency law (A/CN.9/WG.V/WP.54 and Add.1 and 2, A/CN.9/WG.V/WP.57, A/CN.9/WG.V/WP.58, and A/CN.9/WG.V/WP.61 and Add.1)

Report of the Secretary-General on alternative approaches to out-of-court insolvency processes (A/CN.9/WG.V/WP.55)

Report of the Secretary-General on alternate informal insolvency processes (A/CN.9/WG.V/WP.59)

Report on the UNCITRAL/INSOL/IBA Global Insolvency Colloquium (A/CN.9/495)

Reports of UNCITRAL on its thirty-fourth (A/56/17), thirty-fifth (A/57/17) and thirty-sixth sessions (A/58/17)

Reports of Working Group V (Insolvency Law) on the work of its twenty-second (A/CN.9/469), twenty-fourth (A/CN.9/504), twenty-fifth (A/CN.9/507), twenty-sixth (A/CN.9/511), twenty-seventh (A/CN.9/529) and twenty-eighth sessions (A/CN.9/530).

18. The Working Group adopted the following agenda:
  1. Scheduling of meetings.
  2. Election of officers.
  3. Adoption of the agenda.
  4. Preparation of a legislative guide on insolvency law.
  5. Other business.
  6. Adoption of the report.

### **III. Summary of deliberations and decisions**

19. The Working Group reviewed the draft legislative guide on insolvency law on the basis of documents A/CN.9/WG.V/WP.68, A/CN.9/WG.V/WP.63/Add.2 and 14-17 and A/CN.9/WG.V/WP.67. The Working Group began its deliberations with A/CN.9/WG.V/WP.68 and continued with A/CN.9/WG.V/WP.63/Add.17, Add.14 (commencing with section C. Priorities and distribution) to Add.16, Add.2 and A/CN.9/WG.V/WP.67. The Working Group completed its consideration of those remaining addenda of A/CN.9/WG.V/WP.63, as well as A/CN.9/WG.V/WP.68. With respect to the glossary set forth in A/CN.9/WG.V/WP.67, the Working Group completed its review and revision of the terms up to and including the term “preference”. The deliberations and decisions of the Working Group with respect to the various documents are set forth below.

### **IV. Preparation of a legislative guide on insolvency law**

#### **A. Rights of set-off (A/CN.9/WG.V/WP.68)**

##### **Recommendations**

20. The Working Group expressed general approval with the current drafting of the purpose provision of the recommendations on rights of set-off. Regarding recommendation 82, there was general agreement that some redrafting was necessary to ensure that a right of set-off would be protected if it arose prior to commencement, irrespective of whether it was validly exercised prior to or following commencement of insolvency proceedings. It was suggested that the guide make a clear distinction between the application of avoidance provisions to a general right of set-off, as provided in recommendation 82, and to set-off in the context of financial contracts, where it could cause disruption to financial markets. In that regard, it was suggested that the discussion of financial contracts in

paragraph 193 of document A/CN.9/WG.V/WP.68 in the section on general rights of set-off was likely to lead to confusion and should be revised. It was noted that the Working Group would further consider the definition of “set-off” in the context of the glossary.

## **B. Financial contracts and netting (A/CN.9/WG.V/WP.68)**

### **Recommendations**

21. As a preliminary point, there was broad agreement that further consideration should be given to the use of the terms “financial contract” and “financial institution”. It was suggested that the definition of “financial contract” should be as broad and flexible as possible to encompass future developments of new types of financial instruments. An opposing view was that a broad definition might not provide sufficient guidance to legislators. A further suggestion was that a sentence might be added to the beginning of paragraph 195 of document A/CN.9/WG.V/WP.68, defining the minimum necessary characteristics of a financial contract so as to provide some guidance to legislators. Support was expressed for the view that the discussion in the commentary and recommendations should apply clearly to both bilateral and multilateral contracts, since in both instances there was the possibility that multiple transactions would be affected by insolvency with a potential for systemic risk in the market. With regard to “financial institutions”, it was agreed that any definition should envisage a wider application than banks and, in response to a suggestion that “financial intermediary” might be preferable, it was pointed out that the term to be used should include parties to a financial contract (which “financial intermediary” would not). It was also suggested that both of those issues might be further addressed in the context of consideration of the glossary. It was urged that caution be exercised in any redrafting, noting that, as a principle, the draft guide should not interfere with the established rules and special regulatory regimes applicable to financial markets and institutions.

22. In terms of the purpose provision of the recommendations, it was suggested that since the original intention of netting-type provisions was to strictly protect financial markets, subparagraph (b) might be placed before subparagraph (a).

23. Some support was expressed for deleting the phrase “promptly after the commencement of insolvency proceedings” from the first sentence of recommendation 83. Otherwise, the Working Group agreed with the substance of recommendations 83-85 as currently drafted.

24. Suggested changes to recommendation 86 were the deletion of both the first bracketed text, on the basis that it was superfluous, and the second bracketed text, which sought to preserve the application of provisions on fraudulent transactions. Those proposals, together with a suggestion to revise the reference to the application of avoidance provisions to end after the words “exempt from avoidance”, deleting the words “under applicable avoidance provisions of the insolvency law”, were supported. A proposal to retain the second bracketed text, on the application of the rules on fraudulent transactions, did not receive support.

25. There was general agreement to delete both bracketed terms in recommendation 87.

26. A suggestion was made that a new recommendation might be added to the section stating that transactions that were not financial contracts were not intended to be covered by the section and would be covered by general netting and set-off law.

27. The Working Group agreed with the substance of recommendations 88 and 89 as drafted, subject to provision of further guidance on the definition of financial contracts in the context of the glossary.

### **C. Applicable law governing in insolvency proceedings (A/CN.9/WG.V/WP.63/Add.17)**

28. The Working Group held a general discussion on the question of including material on applicable law in the draft guide. The prevailing view was that issues of applicable law were of key importance to insolvency proceedings and that material on the issues involved should be included in the draft guide to provide assistance and guidance to legislators and other users. As to the extent of the material to be included, however, some concern was expressed that discussion and finalization of provisions on applicable law should not delay progress on the guide. The Working Group agreed that the recommendations set forth in A/CN.9/WG.V/WP.63/Add.17 provided an appropriate basis for consideration and discussion of the relevant issues.

29. With respect to the purpose clause, it was suggested that subparagraph (a) was not specific to applicable law but rather of general application to the draft guide and therefore should be deleted. Subparagraphs (b) and (c) were considered to be too narrowly focused on legal relationships with the debtor and support was expressed in favour of expanding both paragraphs to cover insolvency proceedings more generally. It was observed that the opening words of subparagraph (d) were also unnecessarily limiting and should be deleted.

30. A proposal on recommendation 1 that received some support was to retain the chapeau as the operative rule and to place subparagraphs (a)-(k) in the commentary that would need to be drafted to accompany the recommendations. A further proposal that also received some support was to retain subparagraphs (a)-(k) in the recommendation, revising them to reflect the sequence and terminology of the draft guide more closely and addressing possible inconsistency between subparagraph (g), as currently drafted, and recommendation 2. Other drafting changes proposed to subparagraphs (a)-(k) were to delete the references to leases in subparagraph (i) and to add references to other key parts of the insolvency proceedings, including rules governing distribution of proceeds and ranking of claims. Further drafting suggestions were that the title should refer to the law applicable to insolvency proceedings and that the operative rule should then be drafted more directly along the lines of “The law of the place where insolvency proceedings are commenced is the law that applies to the conduct, administration and termination of insolvency proceedings”. Those proposals received some support.

31. With respect to the note to the Working Group preceding the text of recommendation 2, some support was expressed for the view that issues of validity should not be addressed in the context of applicable law. It was proposed that the

focus of recommendation 2 should be on the recognition of the law of another State rather than the possible application of that law and that the bracketed language referring to the “avoidability of a transaction” was the preferred drafting. A further proposal was that recommendations 2 and 3, if both were retained, should be merged as they both provided exceptions to recommendation 1.

32. Support was expressed for the view that because recommendation 3 was a rule of a substantive nature rather than a rule of applicable law, and bearing in mind the discussion in the Working Group on the issues of set-off and netting, it should be deleted. As an alternative text, it was proposed that a general rule, to the effect that conflict of laws rules applicable outside of insolvency should not be affected by the commencement of insolvency proceedings, should be included. That proposal received some support.

33. Wide support was expressed for the deletion of subparagraphs (a) and (c) of recommendation 4, with (b) being retained as a general rule. It was observed, however, that the resulting rule was not specific to insolvency and was not therefore required in a guide on insolvency law. Some concern was also expressed that retention of subparagraph (b) in a rule of general application might suggest that the concept of public policy applicable to insolvency was different to that applicable more generally. A further concern was that the reference to the law applicable to legal relationships might be interpreted to cover a choice both of the law of insolvency and the law of a contract and the former possibility should be specifically excluded. On the basis that subparagraph (b) was to be retained, it was proposed that the word “manifestly” and the words “without regard to ... chosen applicable law” in the chapeau be deleted. Those proposals did not receive support.

34. Concern was expressed as to the meaning of recommendation 5 and whether what was intended was a rule relating to the subordination of the insolvency law to the law of other jurisdictions or a purely domestic rule addressing the relationship between the insolvency law and other law. If the latter meaning was intended, it was observed, the rule had no application in the context of conflict of laws, although it might be useful more generally and should be addressed elsewhere in the draft guide. In that regard it was observed that the need to address the relationship between the insolvency law and other law was pointed out in paragraph 20 of A/CN.9/WG.V/WP.63/Add.2. It was proposed that to make the first sentence a clearer rule on determining applicable law, the words “other laws of the jurisdiction” should be amended to “laws of other jurisdictions”. That proposal received some support.

35. With respect to recommendation 6, support was expressed for the view that although the first sentence might be relevant to recommendation 5, it should be deleted from recommendation 6. One view with respect to the last sentence was that, although reflecting a useful principle, it should be discussed in the commentary and not included as part of the recommendation. An alternative view was that the last sentence served an important purpose in encouraging the adoption of appropriate standards and should therefore be retained.

36. The Working Group considered a proposed revision of the recommendations concerning applicable law as follows:

*[Note to translators: the following text is from A/CN.9/WG.V/XXIX/CRP.4.]*

“Purpose of legislative provisions

The purpose of provisions on the applicable law governing in insolvency proceedings is to:

- (a) facilitate commercial transactions by providing a clear and transparent basis for predicting the law that will apply to insolvency proceedings;
- (b) provide courts with clear and predictable rules for the enforcement of choice of law provisions in contracts with a debtor; and
- (c) provide courts with clear and predictable rules for determining the law applicable to insolvency proceedings.

**Contents of legislative provisions**

*Law of the insolvency proceedings*

(1) The insolvency law of the place where insolvency proceedings are commenced should apply to all aspects of the conduct, administration and conclusion of insolvency proceedings, including:

- [(a) eligibility and commencement criteria;
- (b) creation and scope of the insolvency estate;
- (c) treatment of property of the estate, including the scope of, exceptions to, and relief from application of a stay;
- (d) costs and expenses;
- (e) proposal, approval, confirmation and implementation of a plan of reorganization;
- [(f) treatment of legal acts detrimental to creditors—to be aligned with (2)];
- (g) effect of the commencement of the proceedings upon contracts under which both the debtor and its counterparty have not yet fully performed their respective obligations, including the enforceability of automatic termination and anti-assignment provisions in those contracts;
- (h) conditions under which set-off can occur after commencement of insolvency proceedings;
- (i) powers of the debtor, insolvency representative, creditors and creditors’ committee;
- (j) claims and their treatment;
- (k) priorities for ranking of claims;
- (l) distribution of proceeds of liquidation; and
- (m) resolution and conclusion of the proceedings.]

*Exception to application of law of the insolvency proceedings*

(2) As an exception to recommendation (1), the insolvency law may provide that the law of another State applies to the avoidability of a transaction or set-

off that occurred or an obligation that was incurred before the commencement of insolvency proceedings.

*(Recommendation (3) deleted)*

*Validity of contractual choice of law provisions*

(4) The insolvency law should recognize contractual provisions in which the debtor and its counterparty expressly agree that the law applicable to their legal relationship under the contract will be the law of a specified jurisdiction without regard to the nexus between the transaction or the parties at issue and the chosen applicable law, except where such a provision is viewed as manifestly contrary to a public policy of the jurisdiction whose law would apply in the absence of such a provision.

*Determining the applicable law*

(5) The insolvency law should clearly indicate when the insolvency law would be subordinate to the laws of another jurisdiction.

*(To be reflected elsewhere in the Guide: The insolvency law should recognize and respect rights, claims and other entitlements valid under non-insolvency law except to the extent it may be necessary to modify or postpone those rights, claims and entitlements in order to achieve the specific goals of the insolvency process.)*

(6) Where the law of more than one State is relevant to the application of law other than insolvency law, the insolvency court will need to apply a conflict of laws rule to determine which State's law should apply. The conflict of laws rules should be clear and predictable and should follow modern conflict of laws rules embodied in international treaties and legislative guides sponsored by international bodies."

37. With regard to the purpose provision, it was agreed that the substance of subparagraphs (b) and (c) should be retained with some redrafting to reflect the suggestion that subparagraph (b) was a subset of subparagraph (c) and should therefore be incorporated in subparagraph (c). As a matter of drafting, it was suggested that the words "to insolvency proceedings" be changed to "in the context of insolvency proceedings".

38. After further discussion of subparagraphs (a)-(m) of recommendation 1, it was agreed that they should be retained in the recommendation with the brackets removed. It was also agreed that some alignment of recommendation 1 (f) with recommendation 2 was necessary, perhaps by adoption of language in 1 (f) along the lines of "rules relating to voidness, voidability or unenforceability of legal acts detrimental to creditors". It was also agreed that the term "powers" in recommendation 1 (i) be replaced with the words "rights and obligations" as used elsewhere in the guide.

39. The Working Group agreed that the substance of recommendation 2 was acceptable, subject to some redrafting to make it clear that the intention of the provision was that the law of another State might apply to set-off or to avoidance, rather than to the avoidance of a set-off as the current drafting suggested.



40. With respect to recommendation 4, it was agreed that the public policy standard was the appropriate test and should be retained, with some further consideration to be given to the need to retain the words "... whose law would apply in the absence of such a provision".

41. The suggestion that the word "subordinate" in recommendation 5 be replaced by words to the effect that the insolvency law would "allow the application" of the law of other jurisdictions was supported. It was also agreed that the substance of the note following recommendation 5 be included elsewhere in the guide.

42. After discussion of recommendation 6, the Working Group agreed that the first sentence of the recommendation should be retained in order to provide a rule on the application of law other than the insolvency law, with the words "Where ... is relevant to" to be deleted, and the words "As to" substituted.

43. The UNCITRAL secretariat was requested to reflect the discussion in revising the text of the recommendations on applicable law and to develop a commentary for consideration by the Working Group at its next session. The secretariat was also requested to consult with the Hague Conference on Private International Law.

#### **D. Management of proceedings: priorities and distribution (A/CN.9/WG.V/WP.63/Add.14)**

##### **Recommendations**

44. Regarding the purpose clause of the recommendations section, suggestions for revision included that, in subparagraph (a), the word "paid" should be replaced by "satisfied", and that subparagraph (b) should refer to equal treatment of similarly situated creditors, rather than to creditors of the same class. Otherwise, it was agreed that the square brackets should be removed from subparagraph (c) and the current language of the purpose clause should be retained. It was also agreed that the commentary in paragraph 441 and elsewhere should be amended to reflect the discussion in the Working Group on subparagraph (b), detailing different approaches to treatment of classes, including the use of subclasses, and distinguishing a strict application of the *pari passu* principle in the treatment of classes in liquidation from a more flexible approach in reorganization. As a general point, it was agreed that the application of recommendations 166-171 to liquidation and reorganization needed to be clarified.

45. With regard to recommendation 166, it was agreed that the text " , other than secured claims," should be deleted.

46. While some support was expressed for deleting the underlined text in the first sentence of recommendation 167, the prevailing view was that it should be retained. It was agreed that the second sentence might be redrafted to clarify that the recommendation referred not to the validity of priorities, but to the need to avoid uncertainty regarding the order of priorities by setting out all priorities in the insolvency law. It was observed that a legislative priority granted or calculated by reference to other law would not be invalid simply because it was not included in the insolvency law. It was suggested that a sentence might be added to the end of the recommendation stating that the insolvency law should specify whether and to what

extent priorities created under other law might be recognized in insolvency proceedings.

47. The Working Group agreed that footnote 3 to recommendation 168 should be deleted, though there was some support for including in paragraph 424 of the commentary a discussion of the impact of the approach outlined in footnote 3 on an enterprise mortgage, or floating charge, on the one hand and a fixed security interest on the other. It was also agreed that the recommendation should include the surrender of the encumbered asset to the secured creditor as an option in addition to payment of the proceeds of the sale of the encumbered asset. There was also general support for including in recommendation 168 a second sentence along the lines of the second sentence of recommendation 167 to require disclosure of other priority interests in the insolvency law. A drafting suggestion was to add the words “in liquidation, or pursuant to a reorganization plan” after the words “realization of the security”. It was noted that there were different layers of administrative costs, which might have different ranking and which could be higher in reorganization than in liquidation.

48. A number of drafting suggestions were made concerning recommendation 169. These included in subparagraph (a) deleting the words after “administrative costs and expenses”; clarifying what was meant in subparagraph (b) by the words “claims with priority”; and that, as subparagraph (e) did not represent a payment to creditors, it might be deleted from the recommendation or, alternatively, the chapeau to 169 might be appropriately amended.

49. It was noted that while the underlined language in recommendation 170 referred to subordinated claims where the subordination was contractually agreed, the recommendation might also usefully include other applicable types of subordination, such as equitable subordination. A further suggestion was that the phrase, “unless the senior class agrees otherwise”, should be added to the end of the second sentence, or alternatively moved with that sentence to form a new recommendation. On the same point, it was suggested that, as a general principle, the law should not restrict the parties’ right to contractual autonomy and, therefore, a note might be added to the recommendation section that the general rules stated in recommendations 169-171 might be varied by agreement of the parties.

50. On recommendation 171, it was agreed that the words, “is required to”, should be replaced with “may” or “could”. It was also agreed that, in the interests of not penalizing creditors who had failed to submit a claim for reasons not associated with fault or omission on their part, the second sentence should also refer to safeguards for existing claims that had not yet been submitted. A drafting suggestion was to specify that, in liquidation, distribution should be made promptly and as fully as possible. An alternative view was that the detail in the second sentence of recommendation 171 was too restrictive on the day-to-day management of the estate by the insolvency representative and might be deleted from the text. The UNCITRAL secretariat was requested to prepare a further revision of the recommendations, taking into account the discussion in the Working Group.

## **E. Resolution of proceedings (A/CN.9/WG.V/WP.63/Add.15)**

### **1. Discharge**

#### **Recommendations**

51. It was noted that since the draft guide generally referred to natural person debtors rather than to individual debtors, amendments were required for subparagraph (a) of the purpose clause and recommendation 172. The substance of the purpose clause was otherwise found to be acceptable.

52. Several comments were made with respect to the drafting of the chapeau of recommendation 172. Support was expressed in favour of deleting the reference to the debtor being engaged in business activity, on the basis of the agreement in the Working Group on questions of eligibility and the scope of the draft guide. Support was also expressed in favour of deleting the words “following [liquidation ... proceedings]”, as the question of the timing of the discharge was addressed in subparagraphs (a) and (b).

53. Support was expressed for the view that subparagraph (a) should be treated as establishing the standard of conduct required of the debtor in insolvency proceedings in order for it to be discharged. Wide support was expressed in favour of deleting the bracketed texts “[is honest]” and “[acts in good faith]”, on the basis that those standards proved difficult to implement in practice. It was agreed that the reference to acting fraudulently should be retained and possibly combined with a more objective formulation along the lines of “has performed its obligations under the insolvency law”.

54. With respect to subparagraph (b), support was expressed in favour of retaining both options for determining the period of commencement of the discharge. A further suggestion was to refer to the closing of the proceedings. Support was expressed in favour of deleting the words “during ... to satisfy its obligations”.

55. It was observed with respect to subparagraph (c) that it should address those debts that, by their very nature, should be exempted from any discharge given to the debtor. While noting that the choice of debts to be excluded from a discharge was essentially a matter for States to decide, it was proposed that the only exclusions to be referred to in the recommendation should be those associated with tort claims, family provisions or debts based on a penalty where the alternative was a jail sentence. Other examples could perhaps be discussed in the commentary. In addition, the recommendation should encourage transparency and certainty by requiring all such exclusions to be referred to in the insolvency law.

56. It was observed that the examples included in subparagraph (d) were not appropriate, particularly since preventing the debtor from carrying on business was inconsistent with the idea of providing a discharge; if the debtor was not fit to carry on business it probably should not be discharged. It was proposed that the examples should be deleted or restricted in scope, such as serving on a board of directors as opposed to simply carrying on business. It was pointed out, however, that the intent of subparagraph (d), in many jurisdictions, was not related to the question of whether or not the debtor should be discharged, but rather to restrictions that would apply to the debtor based upon its conduct in the insolvency proceedings.

57. It was noted that the structure of recommendation 172 might require some revision on the basis that subparagraphs (a)-(d) did not reflect different choices as

suggested by the chapeau; rather, subparagraphs (a) and (b) were alternatives, but subparagraphs (c) and (d) could apply irrespective of the choice between (a) and (b).

58. The Working Group considered a proposed revision of recommendation 172 to address discharge in liquidation as follows:

“(172) Where the insolvency law allows the insolvency of natural person debtors, the issue of discharge of the debtor from liability for pre-commencement debts should be addressed.

(a) The discharge may not apply until after the expiration of a specified period of time following commencement, during which period the debtor is expected to cooperate with the insolvency representative;

(b) The debtor may be discharged completely and immediately where the debtor has not acted fraudulently and has cooperated with the insolvency representative in performing its obligations under the insolvency law;

(c) Where certain debts are excluded from the discharge, such debts should be kept to a minimum to facilitate the debtor’s fresh start and should be set forth in the insolvency law;

(d) Where the discharge is subject to conditions, those conditions should be kept to a minimum to facilitate the debtor’s fresh start.”

59. Regarding the revision of recommendation 172, the Working Group agreed that the chapeau be amended to read, “Where natural persons are eligible as debtors under the insolvency law”; that subparagraph (a) remain unchanged; that the words “completely and immediately” be deleted from subparagraph (b); that the current text of subparagraphs (c) and (d) was acceptable; and that a new subparagraph (e) be added to the recommendation to address the issue of revocation of the discharge in circumstances where, for example, it had been obtained by fraud. With respect to the relationship between subparagraphs (a) and (b), it was suggested that subparagraph (b) could be redrafted to take effect when the time period referred to in subparagraph (a) had expired. The two subparagraphs would provide that a time period could be specified, during which the debtor must cooperate with the insolvency representative, and when that period had expired, the discharge would become effective, provided the debtor had cooperated and not acted fraudulently.

60. After discussion, the Working Group requested the UNCITRAL secretariat to prepare a further revision based on the considerations discussed.

61. With respect to recommendation 173, it was observed that the effect of the plan would determine the outcome in terms of discharge and that laws provided for the plan to have different effects. For that reason, some support was expressed in favour of placing the text in the reorganization chapter. A different proposal, which also received support, was to place the text in recommendation 175. It was agreed that the application of the recommendation to both legal person and natural person debtors should be clarified and that the application of the discharge could apply either from the time the plan became effective or from the time it was fully implemented. Where the discharge applied from the time the plan became effective, the commentary should point out that many laws permitted the discharge to be set aside where the plan was not fully implemented.

## 2. Conclusion of proceedings

### Recommendations

62. After discussion, the Working Group agreed with the substance of the purpose clause as drafted. A suggestion was made to include a reference to provision of notice of conclusion of proceedings to interested parties.

63. As a matter of drafting, it was suggested that the opening words of recommendation 174 could be made clearer by referring, for example, to when the estate had been fully liquidated or realized and distributed, rather than “administered”. In response, it was pointed out that the word “liquidated” might preclude conclusion in cases where assets were returned to the creditor and it was suggested that that eventuality should be covered by whatever phrase was chosen. It was agreed that the reference to the discharge of the insolvency representative should be deleted.

64. With respect to recommendation 175, support was expressed for the proposal that only the first sentence was required, as the remaining sentences addressed issues included in the discussion of conversion of reorganization proceedings. With respect to the time at which conclusion might take place, it was pointed out that full implementation might take a considerable amount of time and that an earlier option should be permitted in cases where, for example, the court could determine that there was a reasonable prospect of full implementation. That suggestion was supported. A further suggestion was to include in the first sentence the words “no later than” before the phrase “when the reorganization plan is fully implemented”.

## F. Rights of review and appeal (A/CN.9/WG.V/WP.63/Add.16)

### 1. The debtor

65. The Working Group agreed that the issue of the debtor’s rights of appeal and review should be addressed in the draft guide, since those rights were generally fundamental rights protected by law.

66. It was also agreed that the debtor’s right to seek review or appeal against decisions made in the insolvency proceedings would be limited to those decisions in which the debtor had a direct interest or which affected the rights and obligations of the debtor. It was noted that the right of the debtor had to be balanced against the interests of creditors and, if the right was not limited to those matters in which the debtor had such an interest, there was the potential for the proceedings to be unjustifiably frustrated and delayed and for the incurring of significant costs, with resultant damage to the interest of creditors. It was also agreed that the scope of the right would be more limited in liquidation than reorganization by the very nature of the proceedings and that the exercise of the right might relate to the design of the law. For example, where no automatic discharge was provided the debtor might have a greater interest in the conduct of the proceedings and in decisions affecting its interests.

67. In terms of defining where the debtor might be said to have an interest, it was suggested that the interest had to be legitimate, actual, current and substantive. It

was noted that there would generally be procedural means to address those appeals that could not be justified.

## 2. The insolvency representative

68. A proposal that a section be added on the insolvency representative's right of review and appeal received support. The omission of such a section, it was proposed, might be interpreted by readers of the guide to suggest that the insolvency representative did not have any such rights.

## 3. Creditors

69. As matters of drafting, it was proposed that references to collusion and conspiracy should be added to paragraph 7 of the commentary; that because "administration of the estate" had different meanings in different languages and jurisdictions, another term should be found; and that the word "gain" in paragraph 9 should be changed to "obtain". It was proposed, in addition, that the draft guide should address the balance between individual rights of review and appeal with the collective interests of creditors, as well as discussing the types of orders that might be appealed. It was noted in that regard that some jurisdictions permitted only final orders to be appealed, while others permitted a broader right of appeal. The substance of the material in the commentary was generally found to be acceptable.

70. The Working Group agreed that the draft guide should include recommendations to address the rights of appeal of the debtor.

71. As a general point, it was proposed that the guide should stress the need for such appeals to be determined in a timely manner to avoid delay to the proceedings and the incurring of unnecessary costs. As a matter of drafting, it was suggested that rights of appeal of the debtor, creditors and the insolvency representative could be more concisely addressed if included in one section under the heading of rights of appeal of interested parties, where interested parties would be a defined term. It was proposed that a definition along the following lines could be added to the glossary:

### **"Party in interest**

The debtor, the insolvency representative, a creditor, an equity security holder, a creditor committee [a government authority] or any other person whose rights, property or duties under [or concerning] the insolvency law are affected."

72. It was further proposed that recommendations along the following lines be added to chapter IV:

### **"Right to be heard**

The insolvency law should provide that a party in interest has a right to be heard on any issue which affects its duties under the insolvency law, its rights or property in which it has an interest.

(a) A party in interest may object to any act that requires court approval;

(b) A party in interest may request review by the court of any act for which court approval was not required or not requested;

(c) A party in interest may request any relief available to it under the insolvency law.

**“Right of appeal**

A party in interest may appeal from any order of the court which affects its duties under the insolvency law, its rights or property in which it has an interest.”

73. A number of suggestions were made with respect to the drafting of the proposal. With respect to the definition of “party in interest”, it was queried whether the qualifying phrase commencing “whose rights ...” applied only to “other persons” or would also apply to the debtor, the insolvency representative and the other parties included in the definition. If that qualification did not apply to limit the parties to whom notice must be given, it was pointed out that a requirement to give notice could result in notice being required to be given to a potentially large number of parties whose interests were not affected, for example, to all equity holders. In some cases that could impose a substantial obligation on the insolvency proceedings. A proposal to revise the drafting of the last phrase of the definition to more clearly identify the rights or interests to be affected along the lines of “whose rights, duties under the insolvency law or property in which it has an interest are affected” received some support. Support was also expressed in favour of retaining the reference to “government authority”, although the view was expressed that the term “public authority” might be more appropriate to cover the authorities intended to be included within the meaning of that phrase in the draft guide. A further proposal was to qualify the word “affected”, to require a substantial or direct effect or, alternatively, to include an explanation in the commentary limiting the scope of the word. In response, the view was expressed that because there was an increasing recognition of diffuse interests in different jurisdictions, it might be difficult to reach agreement on the level of qualification to be included in the guide. As a matter of drafting it was proposed that the words “The insolvency law should provide ...” be added at the beginning of the recommendation; that the words “in particular” be added at the end of the chapeau; that the words “any order” be revised to “an order”; that the use of the phrase “equity security holder” and the word “property” be aligned with the terminology used in the other chapters of the draft guide; and that the words “by insolvency proceedings” be added after “are affected”. The secretariat was requested to prepare a revision of the definition and recommendations for inclusion in the draft guide, and to make the necessary revisions to the commentary.

**G. Treatment of corporate groups in insolvency  
(A/CN.9/WG.V/WP.63/Add.16, paras. 15-24)**

74. After discussion, the Working Group agreed not to formulate any recommendations for the section or to define “corporate groups” in the glossary, but that some redrafting of the commentary was necessary. A number of points to be stressed and elaborated on in that redrafting included the following. The law regarding the treatment of corporate groups was an area of great complexity and varied legal approaches, with national laws tending to reflect the specific legal frameworks of the relevant State, making it inappropriate for the Working Group to attempt to formulate specific recommendations in that area. It was also a topic of

great importance and should be addressed by States in sufficient procedural detail to provide certainty to third parties. Alternatives to direct regulation of corporate groups in insolvency should be noted by reference to parts of the insolvency law or other law, such as avoidance or subordination provisions. It was suggested that the commentary's primary focus should be on stating the issues raised by corporate groups in insolvency rather than what actions the insolvency law should provide for the resolution of such problems. As a further point, it was also suggested that a useful clarification to the commentary might be whether, and in what circumstances, a company in a group could commence insolvency proceedings for a related group company.

## **H. Part one. Designing the structure and key objectives of an effective and efficient insolvency regime (A/CN.9/WG.V/WP.63/Add.2)**

75. It was noted that the Commission had reviewed part one of the draft guide at its thirty-sixth session<sup>6</sup> and some minor changes to the text were suggested. It was also noted that the substance of part one as drafted was approved in principle by the Commission.

### **1. Introduction to insolvency procedures (chapeau, paras. 1-2)**

76. The Working Group agreed with the substance of the paragraphs as currently drafted.

#### **(a) Key objectives of an effective and efficient insolvency regime (paras. 3-13)**

77. The Working Group agreed that a new objective, of a higher nature than the objectives currently contained in the text and relating to the insolvency law, might be added at the beginning of the section, outlining what an insolvency system should strive to achieve. The suggested purpose of such an objective was to encourage States to use potential indicators to assess the implementation of the key objectives, such as the availability of finance for start-up and reorganizing companies, domestic and international credit risk assessments and the economic performance of industry sectors. Suggested formulations included "to provide for certainty in the market" and "to promote economic stability and growth".

78. It was suggested that an alternative positive expression of the objective discussed in paragraph 9 of the document could be to "preserve the estate to allow an equitable distribution to creditors".

#### **(b) Balancing the key objectives (paras. 14-18)**

79. It was suggested a footnote might be added to the use of the example of security interests in the first sentence of paragraph 16, noting that steps had been taken in recent years towards harmonizing the law on security interests, such as the United Nations Convention on the Assignment of Receivables in International Trade

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<sup>6</sup> Ibid., paras. 172-182.



and the International Institute for the Unification of Private Law (Unidroit) Convention on International Interests in Mobile Equipment.

80. The Working Group agreed with the substance of the section as currently drafted.

**(c) General features of an insolvency regime (paras. 19-21)**

81. Suggested drafting amendments included replacing the words “suspended by” in subparagraph 19 (f) with “enforced or protected notwithstanding”; and rewording subparagraph 19 (k) to refer to discharge more generally in liquidation. The Working Group agreed with the substance of the section as currently drafted.

**2. Types of insolvency proceedings (chapeau, paras. 22-25)**

82. It was agreed, consistent with the earlier discussions of the Working Group, to remove the references to informal processes from paragraph 22 and throughout the draft guide. The Working Group also agreed that some redrafting of paragraph 25 was necessary to reflect the Working Group’s preference for reorganization, a point which generally should be reflected in the draft guide.

**(a) Liquidation (paras. 26-29)**

83. The Working Group agreed that the last sentence of paragraph 26 should be deleted. It was also agreed that a new paragraph should be added, addressing the fact that sale of a business as a going concern could be conducted in a liquidation proceeding in some jurisdictions, but only under reorganization proceedings in others. It was observed that, in many laws, liquidation did not exclude the possibility of transfer of the business to other companies. A proposal that received support was to make a clear distinction in discussing the various insolvency proceedings between liquidation, transfer of the business from the debtor company to another company (whether that occurred in liquidation or reorganization) and reorganization of the debtor company to preserve the business. Drafting suggestions were that a reference to secured creditors receiving the proceeds of the sale of encumbered assets should be added to the first sentence of paragraph 26 and that as a general matter, the guide should refer to sale or realization of assets, rather than just to their sale.

84. It was observed that the use of the word “universal” in paragraph 27 did not necessarily impart the meaning of wide acceptance in all languages and would warrant some attention in redrafting. It was also suggested that subparagraphs 27 (d) and (e) might be joined, with the addition of the following bridging phrase: “if the business of a debtor cannot be sold as a going concern”.

**(b) Reorganization (para. 30)**

85. The Working Group agreed that a recommendation should be added to the draft guide to the effect that an insolvency law should include reorganization proceedings. It was also agreed that the discussion of reorganization proceedings in the commentary should reflect the Working Group’s view that reorganization proceedings, in principle, were in the interest of all parties.

86. It was proposed that, given the Working Group's preference for reorganization, that section, containing paragraphs 30-55, should precede paragraphs 26-29 concerning liquidation proceedings. That proposal received support.

87. The Working Group agreed to remove the list of names of reorganization proceedings from paragraph 30 and to include it in the glossary. Drafting suggestions for the first sentence in paragraph 30 included inserting the words "company or failing that a" before the word "business" and deleting the rest of the sentence after the word "business".

(i) *Formal reorganization proceedings (paras. 31-36)*

88. A drafting suggestion was to delete the initial lines of paragraph 31 and begin the paragraph at the words, "not all debtors" in the second sentence.

(ii) *Informal and expedited reorganization processes (paras. 37-55)*

89. The Working Group agreed that, in general, the current text on informal processes should be retained, though with some specific redrafting. It was agreed that a statement should be made in the commentary that the viability and effectiveness of informal processes as an alternative to formal insolvency proceedings was dependent on the existence of a strong institutional framework in a State, which would include an effective, efficient and certain legal and judicial structure. That statement could be supported by a cross reference to the discussion of the institutional framework in the draft guide. The commentary should also clearly state that informal processes were voluntary and contractual in nature and, if unsuccessful, must be followed by formal proceedings, which would include the possibility of expedited proceedings. It was also agreed to clarify in paragraphs 53-55 that a clear distinction could be made between out-of-court informal processes and court-based expedited proceedings. It was suggested that the substantive discussion of informal processes and expedited proceedings should be separated more clearly in the draft guide. Another suggestion was that the commentary should be informed by the fact that some proceedings worked well precisely because they were regulated, while other processes succeeded because they were not.

(c) **Administrative processes (paras. 56-57)**

90. The Working Group agreed that the substance of paragraphs 56 and 57 as drafted were acceptable.

(d) **Structure of the insolvency regime (paras. 58-64)**

91. With respect to paragraphs 58-64, it was suggested that it should be made clear that the section related only to formal insolvency regimes and, accordingly, should be relocated earlier in part one and on that basis could perhaps be shortened. It was further suggested that the section should make clear the preference for reorganization where the business was viable.

92. Suggestions of a drafting nature included changing the heading to reflect not the structure of the regime, but the organization of the insolvency law; deleting the words "Although ... proceedings" in the first sentence of paragraph 58; deleting the words "and with a view ... objectives" from paragraph 59; deleting the words

“Where ... in the insolvency law” from the beginning of paragraph 60; and substituting the word “continued” for the word “granted” at the end of paragraph 61.

### **I. Approval of a reorganization plan by classes of creditors (A/CN.9/530, para. 84 and A/CN.9/WG.V/WP.63/Add.12, recommendations 129 and 130)**

93. It was recalled that the Working Group, at its twenty-eighth session, had deferred its decision on whether all classes of creditors were required to approve a reorganization plan, or whether a more complicated formula that took into account the different priorities and interests of creditors should be adopted. It was also recalled that recommendations 129 and 130 of the draft guide, revised in accordance with discussions in the Working Group, provided firstly, that the insolvency law should specify, where voting on the plan was conducted in classes, how the vote achieved in each class would be treated for the purposes of approval and that different approaches could be taken, including that approval could require a specified majority of classes or approval by all classes, and secondly, where approval of all classes was not required, the law should address the treatment of those classes that had not voted in support of a plan that was otherwise approved by the requisite number of classes.

94. After discussion, the Working Group agreed with the general substance of the recommendations, subject to some clarification in the commentary. It was suggested, specifically, that what was more important than approval by the requisite number of classes, was approval by the requisite classes, taking into consideration issues of priority and interests. It was suggested that although the commentary already provided a satisfactory discussion, further clarification could be included as to different options with respect to approval by classes and relevant protections required to make the plan binding on dissenting classes of creditors.

### **J. Glossary (A/CN.9/WG.V/WP.67)**

95. As a general approach, it was agreed that the glossary should only make reference to the UNCITRAL Model Law on Cross-Border Insolvency and not cite other texts as source material, although it was noted that there might be some advantage in including those references in the footnotes to assist readers seeking further information in regard to defined terms. It was agreed that the definitions in the glossary should focus on the meaning in the text of the guide and not on the usage of terms in any particular jurisdiction.

#### **1. Notes on terminology (paras. 1-5)**

96. Some concern was expressed with regard to the possible extension of the definition of “court” in paragraphs 2 and 3 to include an administrative authority, on the basis that there might be some potential for confusion with the administrative processes described in paragraph 56 of the draft guide (see A/CN.9/WG.V/WP.63/Add.2). It was agreed that clarification was required.

97. Further suggestions for rules of interpretation to be added to paragraph 5 included an explanation of the use of “may” and “should” based on the difference

between permission and instruction; and that the phrases “such as” and “for example”, might be treated in the same way as “include”.

## **2. Terms and definitions**

### **Administrative claim or expense**

98. Some support was expressed for deleting the words “that are generally accorded priority over unsecured claims and” from the definition on the basis that priority was not an essential part of the definition and should be dealt with in the chapter on priorities. An alternative formulation proposed was to refer to the expenses that had to be met, rather than to the priority they might be accorded. As a matter of drafting, it was suggested that the words “relate to” in the second line should be replaced with “include”. In response to a proposal to add to the definition a reference to costs incurred in the operation of a business where it was authorized to continue, a more generic description, such as “expenses for the continued operation of the debtor” was proposed. It was noted that in addition to the insolvency representative, that phrase might also refer to the debtor and the creditor committee.

### **Application for commencement of insolvency proceedings**

99. Drafting suggestions included to insert the words “entities or persons such as” or, alternatively, “inter alia” after the words “made by”; adding the phrase “upon the filing of insolvency proceedings by a party other than the debtor” to the end of the first sentence; and deleting the second sentence.

### **Assetless estate**

100. There was general agreement that the term, “assetless estate” did not accurately describe the concept discussed in the guide and should be replaced by terminology referring to debtors with insufficient assets. It was also agreed that discussion of the concept should be restricted to the commentary and removed from the glossary.

### **Avoidance action**

101. It was agreed that the definition of “avoidance action” might be redrafted to focus on the essential legal effects of the term, leaving discussion of examples to the commentary. Drafting suggestions included deleting the references to application and commencement; adding “for reasons related to insolvency” to the end of the first sentence (with a cross-reference to the defined term, “insolvency”); adding as a reason for avoidance actions “in the collective interests of creditors or the estate”; and deleting the second sentence. It was also suggested that the definition might be assisted by the addition to the glossary of definitions of “undervalued transaction” and “creditor”. It was noted that recommendation 69 of the draft guide referred to most of the issues discussed by the Working Group and might assist in the redrafting. Some support was expressed for limiting the scope of the definition to transactions occurring before commencement.

**Burdensome assets**

102. The Working Group agreed to shorten the definition of “burdensome assets” by deleting the words “where the value of the secured claim ... the assets are not essential to a reorganization”. There was also support for replacing the idea of an asset with a negative value with a reference to an asset of no value and deleting the remaining text from “or where the asset is unsaleable”. It was suggested that the words “to the insolvency estate” might be added in the first line after the word “value”.

**Centre of main interests**

103. Regarding the term “centre of main interests”, drafting suggestions included retaining the reference to the European Community Regulation but moving it to a footnote.

**Claim**

104. A suggestion to delete the word “enforceable” and add the words “to claim from the debtor” after the word “right” was supported. It was also suggested that the word “judgement” be replaced by “debt” or be retained and followed by, “or contract”. It was also suggested that “judgement” should be a defined term.

**Close-out netting**

105. It was agreed the term should be deleted and that relevant material could be included in the definition of “netting” as appropriate.

**Commencement of proceedings**

106. With regard to the term “commencement of proceedings”, the Working Group agreed to retain the first line of the definition and the bracketed text without the brackets, and to delete the words “in some ... proceedings”. It was also suggested that the definition might be redrafted to emphasize that commencement was an event that defined the relevant date, rather than overemphasizing the importance of the date itself.

**Court**

107. Regarding the definition of “court”, it was questioned whether both the discussion in paragraphs 2 and 3 as well as a separate definition were required. A proposal to delete the reference to other competent authorities was not supported.

**Cram-down**

108. The Working Group agreed to delete the definition of “cram-down” from the glossary.

**Creditor committee**

109. Regarding the term “creditor committee”, it was agreed that the three bracketed phrases should be deleted from the definition. Further drafting suggestions were to add the phrase “in accordance with the insolvency regime of each country” after the words “representative body” and to delete the words “to act ... creditors and”.

**Debtor**

110. The Working Group agreed that the term should be amended by deleting both the words “including the management ... legal person” and the words in square brackets at the end of the sentence.

**Discharge**

111. It was noted that since discharge did not always require a court order and since not all liabilities were always discharged, those references should be deleted. It was further suggested that the words “including contracts ... reorganization” should be deleted. Those changes were supported.

**Disposition**

112. Some support was expressed in favour of redrafting the definition along the lines of “Every means of transferring or parting with an asset or an interest in an asset, whether in whole or in part”. It was observed that some clarification was required to ensure that the draft guide did not refer to the disposal of an asset by way of encumbrance to avoid the circularity that would obtain if encumbrance was already defined as a means of disposal.

**Encumbered asset**

113. It was noted that the term “secured asset” had been replaced by “encumbered asset” in the draft guide to align the text with the draft legislative guide on secured transactions. It was agreed that the words “movable or immovable” and the second sentence should be deleted; and that the word “granted” should be replaced with the words “obtained by”.

**Establishment**

114. The Working Group agreed that the substance of the definition was acceptable.

**Financial contract**

115. It was recalled that the definition of the term “financial contract” had been discussed in the context of set-off and netting and it was agreed that, pending finalization of the discussion of that issue by the Working Group, the definition in the glossary should be placed in square brackets.

**Going concern**

116. It was agreed that the glossary should define the term “sale as a going concern” to cover the sale or transfer of a business in whole or in a substantial part, as opposed to sale of the separate assets of the business.

**Insolvency**

117. The Working Group agreed that the definition should take account of the commencement standard set forth in the recommendations on commencement of proceedings.

**Insolvency estate**

118. It was agreed that the words after the first sentence should be deleted and that the words “or supervised” should be added after “controlled”. Since the words relating to the time of constitution of the estate were not accurate, they should be deleted. A related suggestion was to include a definition of “asset” in the glossary to facilitate understanding of the terms using that word.

**Insolvency proceedings**

119. After discussion, a definition along the lines of “collective judicial or administrative proceeding for the purpose of either liquidation or reorganization of the debtor’s business, conducted according to the insolvency law” was widely supported.

**Insolvency processes**

120. The Working Group agreed that only the first sentence should be retained and, recalling the previous decision with respect to the use of the word “processes”, that the term to be defined should be amended to read “voluntary restructuring arrangement” or “informal reorganization procedure”.

**Insolvency representative**

121. After discussion, the Working Group agreed to a definition along the following lines: “A person or body responsible for administering the insolvency estate”.

**Involuntary proceedings**

122. Some support was expressed in favour of deleting the terms involuntary and voluntary proceedings on the basis that they only applied in some jurisdictions and could be replaced in the draft guide by references to the party making the application for commencement, such as a debtor or creditor application. It was noted that the terminology used would have to be wide enough to cover applications by government authorities that were not creditors or applications by other interested parties.

**Liquidation**

123. A proposal to adopt a definition along the lines of “proceedings to assemble and reduce the debtor’s assets to money for distribution in accordance with the insolvency law” was supported.

**Margin, netting, netting agreement and set-off**

124. With respect to “margin”, it was suggested that footnote 5 to A/CN.9/WG.V/WP.68 was sufficient explanation of the term and that it did not need to be also included in the glossary, especially in the terms drafted for the footnote. After discussion, it was agreed to defer the discussion of the terms, “margin”, “netting”, “netting agreement” and “set-off” until the Working Group completed its deliberations on the subject of financial contracts at its next session.

**Ordinary course of business**

125. A proposal to define the term along the lines “transfers or transactions consistent with operation of the business prior to insolvency proceedings” was supported.

**Pari passu**

126. Proposals to substitute “creditors of the same class” with “similarly situated creditors”, “paid” with “satisfied” and “equally” with either “rateably” or “proportionate to their claim” were supported.

**Perfection, secured creditor, security interest**

127. A proposal to reconsider these definitions in the light of the definitions included in the draft legislative guide on secured transactions was supported.

**Post-commencement creditor**

128. The Working Group agreed that the term to be defined should be “post-commencement claim” rather than “post-commencement creditor” and, that if a definition was required on the basis of usage of that term in the draft guide, a definition along the lines of “a claim arising from an act or omission occurring after commencement” should be included.

**Preference**

129. Reference was made to recommendation 70 (c) and preferential transactions in the context of avoidance proceedings and it was suggested that to the extent a definition was required, the terms of the recommendation should be used. It was suggested that the definition should indicate that it was an act by the debtor that would give rise to a preference.

130. The terms liquidity and illiquidity were suggested for inclusion in the glossary.

131. For lack of time, the Working Group did not complete its consideration of the glossary.



**B. Note by the Secretariat on the draft legislative guide on insolvency law:  
glossary, working paper submitted to the Working Group on Insolvency Law  
at its twenty-ninth session**

**(A/CN.9/WG.V/WP.67) [Original: English]**

**A. Notes on the terminology used in the Guide**

1. The following terms are intended to provide orientation to the reader of the Guide—many terms such as “secured creditor”, “liquidation” and “reorganization” may have fundamentally different meanings in different jurisdictions and the inclusion of a definition in the Guide may assist in ensuring that the concepts as discussed in the Guide are clear and widely understood.

*- References in the Guide to the “court”*

2. The Guide assumes that there is reliance on court supervision throughout the insolvency proceedings which may include the power to commence insolvency proceedings, to appoint the insolvency representative, to supervise its activities and to take decisions in the course of the proceedings. Although this reliance may be appropriate as a general principle, alternatives may be considered where, for example, the courts are unable to handle insolvency work (whether for reasons of lack of resources or lack of requisite experience) or supervision by an administrative agency is preferred (see Part two, chapter IV. D, Institutions).

3. For the purposes of simplicity the Guide uses the word “court” in the same way as article 2 (e) of the UNCITRAL Model Law on Cross-Border Insolvency to refer to a judicial or other authority competent to control or supervise an insolvency proceeding.

*- Reference to the “law”*

4. References in the Guide to “the law” are to the insolvency law unless otherwise specified.

*- Rules of interpretation*

5. “Or” is not intended to be exclusive; use of the singular also includes the plural; and “include” and “including” are not intended to indicate an exhaustive list.

**B. Terms and definitions**

**Administrative claim or expense**

Claims that are generally accorded priority over unsecured claims and which relate to costs and expenses of the proceedings such as remuneration of the insolvency representative and any professionals employed by the insolvency representative, debts arising from the proper exercise of the insolvency

representative's functions and powers, costs arising from continuing contractual obligations, and costs of proceedings [see para. 426, A/CN.9/WG.V/WP.63/Add.14].

#### Application for commencement of insolvency proceedings

An application for the commencement of an insolvency proceedings which may be made by the debtor, creditors or a government authority. Under some insolvency laws, the application may operate to automatically commence insolvency proceedings; under other laws the court must determine whether the commencement criteria are met (sometimes referred to as the commencement or insolvency decision) before proceedings can commence.

**Assetless estate** An insolvency estate which does not have sufficient assets to pay for its administration under the insolvency law.

**Avoidance action** Action which allows transactions occurring prior to the application for commencement of insolvency proceedings or commencement of insolvency proceedings to be cancelled or otherwise rendered ineffective. Transactions that may be avoided include transactions intended to defeat, hinder or delay creditors; undervalued transactions, preferential transactions; and transactions involving related persons.

**Burdensome assets** Assets that may have a negative or insignificant value, such as where the value of the secured claim exceeds the value of the encumbered asset; where the assets are not essential to a reorganization; where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable by the insolvency representative, such as where the asset is unique or does not have a readily apparent market or market value.

**Centre of main interests** The place where the debtor conducts the administration of its interests on a regular basis and that is therefore ascertainable by third parties [EC Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings, recital (13)].

**Claim** Enforceable right to money or assets which may be based upon a judgement, may be liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, fixed or contingent.

**Close-out netting** A contractual provision [or, in the absence of any such provision, any statutory rule that supersedes a contractual arrangement] by which, on the occurrence of an event of default, whether through the operation of netting or set-off or otherwise: (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount

representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party [see EU Directive on financial collateral arrangements (2002/47)].

#### Commencement of proceedings

The date as of which the effects of insolvency are applicable or [date as of which the judicial decision to commence insolvency proceedings becomes effective, whether it is a final decision or not], in some jurisdictions referred to as “opening” of proceedings.

#### Court

A judicial or other authority competent to control or supervise an insolvency proceeding [UNCITRAL Model Law on Cross-Border Insolvency, art. 2 (e)]. [*Definition to address issues of locality and subject matter jurisdiction*]

#### Cram-down

A mechanism that will enable the support for a reorganization plan of one class of creditors to be used to make the plan binding on other classes without their consent.

#### Creditor committee

Representative body appointed by [the court] [the insolvency representative] [creditors as a whole] to act on behalf and in the interests of creditors and having consultative and other powers as specified in the insolvency law.

#### Debtor

A natural or legal person, including the management or other persons in control of the legal person, engaged in a business, which meets the criteria for commencement of insolvency proceedings; [or a natural or legal person that is indebted to a creditor].

#### Discharge

A court order releasing a debtor from all liabilities that were, or could have been, addressed in the insolvency proceedings, including contracts that were modified as part of a reorganization.

#### Disposition

Any transfer of title whether outright or by way of security [or lease] and any grant of a security interest whether possessory or non-possessory [Hague Conference on Private International Law: Preliminary Draft Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary, April 2002].

#### Encumbered asset

An asset or property, movable or immovable, in respect of which a security interest has been granted to a creditor. If an obligation is not satisfied the asset or property subject to the security interest may be recovered or held, or the value realized by the creditor holding the security interest.

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Establishment	Any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services [UNCITRAL Model Law on Cross-Border Insolvency, art. 2 (f)].
Estate	See Insolvency estate.
Financial contract	Means any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above [UNCITRAL Convention on the Assignment of Receivables in International Trade (2002), art. 5 (k)].
Going concern	The sale of a business as a “going concern” is where the business is continued after commencement of insolvency proceedings and sold as a working whole, as opposed to a piecemeal sale of individual assets of the business.
Insolvency	When the debtor is unable to pay its debts and other liabilities as they [fall due] [mature] or when the value of debts and liabilities of the debtor exceeds the value of its assets.
Insolvency estate	Assets and rights of the debtor that are controlled by the insolvency representative and subject to the insolvency proceedings and which is constituted on commencement of proceedings. The estate would include [from chapter III. A. 2 (a)] assets and rights in which the debtor has an interest, whether or not they are in the possession of the debtor at the time of commencement or insolvency proceedings, including all tangible (whether movable or immovable) and intangible assets. [From footnote 4 to rec. (27) A/CN.9/WG.V/WP.63/Add.5, p. 7.] Intangible assets may be differently defined according to national law, but may include intellectual property, bills of lading, securities and financial instruments, policies of insurance, contract rights (including those relating to property owned by third parties), and rights of action arising from a tort.
Insolvency proceedings	Collective judicial or administrative proceedings, including an interim proceeding, for the benefit of creditors and others conducted according to the insolvency law [in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority] [which involve the [partial or total] divestment of the debtor and the appointment of an insolvency representative] for the purpose of either liquidation or reorganization of the business.
Insolvency processes	Insolvency processes are informal processes that are not regulated by the insolvency law and will generally involve negotiation between the debtor and some or all of its creditors. Often these processes have been developed through the banking

and commercial sectors and typically provide for some form of reorganization of the insolvent debtor. Whilst not regulated by an insolvency law, these informal reorganization processes nevertheless depend for their effectiveness upon the existence of an insolvency law which can provide some indirect incentive or persuasive force to achieve a reorganization. Also referred to as informal or out-of-court processes.

Insolvency representative

A person or body including one appointed on an interim basis, authorized in an insolvency proceeding to administer the reorganization or liquidation of the debtor's assets or affairs [UNCITRAL Model Law on Cross Border Insolvency, art. 2 (d)] (see also "interim insolvency representative"). An interim insolvency representative may be appointed by the insolvency court in case of a serious crisis of the debtor which prevents the normal operation of its business, and is required to ensure, temporarily, the further operation of the business in connection with suspension of the debtor or of the debtor's management (possibly in connection with reorganization).

Involuntary proceedings Insolvency proceedings commenced on the application of a party other than the debtor such as creditors or a public authority.

Liquidation Process of assembling and selling a debtor's assets in an orderly and expeditious fashion in order to distribute the proceeds of sale to creditors according to established law and dissolve (where the debtor is a corporate or other legal entity) or discharge (where the debtor is an individual) the debtor either by way of a piecemeal sale or a sale of all or most of the debtor's assets in productive operating units or as a going concern [see World Bank Principles and Guidelines, 2001]. Other terms for this type of proceeding include winding up, bankruptcy, *faillite*, *quiebra*, and *Konkursverfahren*.

Margin The process of posting additional cash or securities as a security interest for the transactions in accordance with a contractual formula that accounts for fluctuations in the market value of the contract and the existing security. For example, on a swap, a margin of 105 per cent might be required to maintain the termination value of the contract. If the security position falls to 100 per cent, an additional margin might be required to be posted.

Netting In one form it can consist of set-off (see "set-off") of non-monetary fungibles (such as securities or commodities deliverable on the same day, known as settlement netting) and in its more important form it consists of a cancellation by a counterparty of open contracts with the debtor, followed by a set-off of losses and gains either way (close-out netting).

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Netting agreement	<p>An agreement between two or more parties that provides for one or more of the following:</p> <p>(i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;</p> <p>(ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or</p> <p>(iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements. [UNCITRAL Convention on the Assignment of Receivables in International Trade (2002), art. 5 (1)].</p>
Ordinary course of business	<p>The usual manner and range of a business especially considered in relation to the amount, circumstances, and validity of a particular transfer.</p>
<i>Pari passu</i>	<p>The principle according to which creditors of the same class are treated equally [and are paid proportionately out of the assets of the estate].</p>
Perfection	<p>Completion of any steps necessary to render a disposition effective against persons who are not parties to that disposition: [Hague Conference on Private International Law: Preliminary Draft Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary, April 2002].</p>
Post-commencement creditor	<p>A creditor whose claim arises after commencement of the insolvency proceedings.</p>
Preference	<p>A payment or other transaction made by an insolvent debtor which places a creditor in a better position than it would have been otherwise to the detriment or prejudice of the general body of creditors [other than in the normal course of trade].</p>
Priming lien	<p>A priority given to lenders of post-commencement finance which ranks ahead of all creditors, including secured creditors.</p>
Priority	<p>The right of a person in preference to the right of another person and, to the extent relevant for such purpose, includes the determination of whether the right is a personal or a property right, whether or not it is a security right for indebtedness or other obligation and whether any requirements necessary to render the right effective against a competing claimant have been satisfied [UNCITRAL Convention on the Assignment of Receivables in International Trade, art. 5].</p>

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Priority claim	A claim that will be paid out of available assets before payment of general unsecured creditors.
Priority rules	The rules by which distributions are ordered among creditors and equity interests.
Protection of the value of encumbered assets	Measures directed at maintaining the economic value of a security interest during the insolvency proceedings (in some jurisdictions referred to as “adequate protection”). This protection may be particularly relevant where the value of the secured claim is greater than the value of the encumbered asset or even where the value of the encumbered asset exceeds the value of the secured claim, but the value of the encumbered asset is diminishing and ultimately may be insufficient to satisfy the secured claim. Such diminution in value may be affected by the application of the stay to secured creditors or by the use of the encumbered asset in the insolvency proceedings (see recommendation (42)). Protection may be provided by way of cash payments, provision of alternative or additional security or by other means as determined by a court to provide the necessary protection. Where the value of the encumbered asset exceeds that of the secured claim, and is unlikely to diminish, protection may not be required.
Related person	A person who is or has been in a position of control of the debtor including a director or officer of a legal entity, a shareholder or member of such legal entity, a director or officer or shareholder of a legal entity that is related to the debtor, including any relative of such a person; a “relative” in relation to a related person means the spouse, parent, grandparent, son, daughter, brother or sister of the related person.
Reorganization	Process by which the financial well-being and viability of a debtor’s business can be restored and the business continue to operate, using various means possibly including debt forgiveness, debt rescheduling, debt-equity conversions and sale of the business (or parts of it) as a going concern. Other terms for this type of proceeding include rescue, restructuring, turnaround, rehabilitation, arrangement, composition, <i>concordat préventif de faillite</i> , <i>suspensión de pagos</i> , <i>administración judicial de empresas</i> , and <i>Vergleichsverfahren</i> .
Reorganization plan	A plan by which the financial well-being and viability of the debtor’s business can be restored. The insolvency law may provide for the plan to be submitted by various parties (the debtor, the creditors, the insolvency representative) and may require confirmation of the plan by the court following its approval by the requisite number of creditors. The plan may address issues such as timing of the process, commitments to be undertaken, terms of payment and securities to be offered to

	creditors, avoidance actions to be filed and treatment of pending contracts including employment contracts.
Retention of title (title financing)	Provision of a contract for the supply of goods which purports to reserve ownership of the goods with the supplier until payment of the purchase price.
Secured claim	A claim assisted by a security interest taken as a guarantee for a debt enforceable in case of the debtor's default when the debt falls due.
Secured creditor	A creditor holding either a security interest covering all or part of the debtor's assets or a security interest in a specific asset entitling the creditor to priority ahead of other creditors with respect to the secured asset.
Secured debt	[Aggregate amount of secured claims] or [claims pertaining to secured creditors].
Security interest	A right or interest granted by a party committing the party to pay or perform an obligation. Whether established voluntarily by agreement or involuntarily by operation of law, a security interest generally includes, but is not necessarily limited to, mortgages, pledges, charges and liens [World Bank Principles and Guidelines, 2001]; c.f. "Securities" means any shares, bonds or other financial instruments or assets (other than cash), or any interest therein [Hague Conference on Private International Law: Preliminary Draft Convention on the Law Applicable to Certain Rights in Respect of Securities held with an Intermediary, April 2002].
Set-off	Where a claim for a sum of money owed to a person is "set-off" (balanced) against a claim by the other party for a sum of money owed by that first person. A set-off may operate as a defence in whole or part to a claim for a sum of money.
Settlement payment	<i>[to be completed]</i>
State-owned enterprise	<i>[to be completed]</i>
Stay of proceedings	A measure which prevents the commencement, or suspends the continuation, of judicial, administrative or other individual actions concerning the debtor's assets, rights, obligations or liabilities, including the perfection or enforcement of any security interest; and prevents execution against the assets of the insolvency estate, the termination of a contract with the debtor, and the transfer, encumbrance or other disposition of any assets or rights of the insolvency estate (recommendation (35)).
Superpriority	A priority that will result in claims to which the superpriority attaches being paid before administrative claims.
Suspect period	The period of time by reference to which certain transactions may be subject to avoidance. The period is generally calculated



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	retroactively from the date of the application for commencement of insolvency proceedings or from the date of commencement.
Unsecured creditor	Any creditor who does not hold security or any ordinary creditor who has no preferential rights.
Unsecured debt	Aggregate amount of claims not supported by security.
Voluntary proceeding	Insolvency proceedings commenced on the application of the debtor.

**C. Note by the Secretariat on the draft legislative guide on insolvency law, working paper submitted to the Working Group on Insolvency Law at its twenty-ninth session**

**(A/CN.9/WG.V/WP.68) [Original: English]**

1. The following paragraphs and recommendations were developed in response to the discussion of set-off and financial contracts and netting by the Working Group at its twenty-eighth session (New York, 24-28 February 2003) at the initiative of the International Monetary Fund and in cooperation with a group of experts. The purpose of the revised paragraphs is to provide a clear explanation of the relevant concepts and issues arising in respect of rights of set-off and financial contracts and netting, which are then reflected in the recommendations.
2. The Working Group may wish to consider whether any further explanatory material should be included in the commentary section. Concerns expressed in the report of the twenty-eighth session of the Working Group are reflected in document A/CN.9/530 paragraphs 26 to 37 and the previous draft of this sections appears in A/CN.9/WG.V/WP.63/Add.9, paragraphs 190-202.
3. The following paragraphs would appear in Part Two, Chapter III, "Treatment of assets on commencement of insolvency proceedings" of the draft legislative guide, following the section on Avoidance.

**F. Rights of set-off**

189. The enforcement under insolvency law of rights of set-off of mutual obligations arising out of pre-commencement transactions or activities of the debtor is important not only to commercial predictability and the availability of credit, but also because it avoids the strategic misuse of insolvency proceedings. For these reasons, it is highly desirable that an insolvency law affords protection to such set-off rights.

190. In the majority of jurisdictions, set-off rights are not affected by the stay in insolvency and may be exercised after the commencement of insolvency proceedings, irrespective of whether the mutual obligations arose under a single contract or multiple contracts and irrespective of whether the mutual obligations matured before or after commencement of insolvency proceedings. In some jurisdictions a distinction is made; post-commencement set-off of obligations maturing prior to the commencement of insolvency proceedings is permitted, but post-commencement set-off of obligations maturing after the commencement of insolvency proceedings is limited or disallowed.

191. An alternative approach preserves set-off rights regardless of whether the mutual obligations matured prior to or after the commencement of insolvency proceedings, but applies the stay to the exercise of those rights in the same manner as the stay applies to the exercise of rights of secured creditors. In systems adopting

this alternative approach, the creditor is treated as secured to the extent of its own valid but unexercised set-off rights and these rights are protected in a manner similar to the protections afforded to security interests.<sup>1</sup>

192. Insolvency laws almost universally include provisions that permit the insolvency representative to seek to avoid the effects of certain pre-commencement actions by creditors designed to enhance set-off rights (such as purchasing claims at a discount with the intention of building up set-off rights). The nature and scope of these provisions varies.

193. Set-off rights often arise from the termination of multiple open contracts, such as financial contracts. Accordingly, the treatment of set-off rights in insolvency has a relationship to the treatment of those contracts under the insolvency law. To the extent the insolvency law does not permit contracts to be freely terminated, or subjects set-off rights to application of the stay, disallowance or other limitations, exceptions that appropriately address categories of contracts, like financial contracts, are needed so that those limitations will not apply. It is desirable that the exceptions for these types of contracts also extend to avoidance provisions that might apply to financial contracts and any restrictions that would limit the extent to which security can be applied to unsatisfied financial contract obligations remaining after offsets are completed.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on set-off is to:

(a) Provide certainty with respect to the effect of the commencement of insolvency proceedings upon the exercise of set-off rights;

(b) Specify the types of obligations that may be set-off after commencement of insolvency proceedings;

(c) Specify the effect of other provisions of the law (e.g. avoidance provisions and the stay) on the exercise of rights of set-off.

### **Content of legislative provisions**

[(82) The law should protect a right of set-off existing under general law that was validly exercised prior to the commencement of insolvency proceedings, subject to the application of avoidance provisions.]<sup>2</sup>

## **G. Financial contracts and netting**

194. Financial contracts have become an important component of international capital markets. Among other things, they enhance the availability of credit and are

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<sup>1</sup> See Part Two, Chapter III.B.8.

<sup>2</sup> See A/CN.9/530, para. 33 for the decision of the Working Group at its twenty-eighth session.

an important means of hedging against exchange rate, interest rate and other market fluctuations. Because of the way these transactions are structured and documented, it is imperative that there be certainty as to what happens when one of the parties to such contracts fails to perform—including for reasons of insolvency.

195. Financial contracts include, among other things, securities contracts, commodities contracts, forward contracts, options, swaps, securities repurchase agreements, master netting agreements and other similar contracts. Debtors often enter into multiple financial contracts with a given counterparty in a single course of dealing, and the availability of credit is enhanced if rights under these contracts are fully enforceable in accordance with their terms, thereby permitting counterparties to extend credit based on their *net exposure* from time to time after taking into account the value of all “open” contracts.

196. Upon commencement of insolvency proceedings, counterparties seek to “close-out” open positions and “net” all obligations arising under financial contracts with the debtor. “Close-out netting” embraces two steps: first, termination of all open contracts as a result of the commencement of insolvency proceedings (close-out); second, the set-off of all obligations arising out of the closed out transactions on an aggregate basis (netting).

197. Permitting “close-out netting” after the commencement of insolvency proceedings is an important factor in mitigating systemic risks that could threaten the stability of financial markets. The value of or exposure under a financial contract may vary significantly from day to day (and sometimes from hour to hour) depending on conditions in the financial markets. Accordingly, the value of these contracts can be highly volatile. Counterparties typically mitigate or hedge the risks associated with these contracts by entering into one or more “matching” or “hedge” contracts with third parties, the value of which fluctuates inversely with the value of the debtor’s contract.<sup>3</sup>

198. Whether or not the debtor performs its contract with the counterparty, the counterparty must perform the hedge contract it enters into with third parties. If the debtor becomes insolvent and cannot perform its contract with the counterparty, the counterparty becomes exposed to market volatility because the counterparty’s hedge positions are no longer “covered” by its contract with the debtor. Under such circumstances, the counterparty typically seeks to “cover” the hedge contracts by entering into one or more new contracts so as to limit its exposure to future market fluctuations. The counterparty cannot, however, cover in this manner until it determines with certainty that it will not be required to perform its contract with the debtor. The counterparty relies on the ability to “close-out” the debtor’s contract, which permits it to “cover” promptly after the commencement of insolvency proceedings.

199. Absent the ability to close-out, net and set-off obligations in respect of defaulted contracts promptly after commencement as described above, a debtor’s failure to perform its contract (or its decision to perform profitable contracts and not perform unprofitable ones) could lead the counterparty to be unable to perform its related hedge contracts with other market participants. The insolvency of a significant market participant could result in a series of defaults in back-to-back

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<sup>3</sup> The reference to a “contract” in this section includes the possibility of one or more contracts.

transactions, potentially infecting other market participants with financial distress and, in the worst case, resulting in the financial collapse of other counterparties, including regulated financial institutions. This domino effect is often referred to as “systemic risk”, and is cited as a significant policy reason for maximizing the predictability of outcomes and reducing risk to market participants in this area.

200. Additional systemic risks can arise from concerns over the finality of payments and settlements of financial contracts that take place in central payment and settlement systems. These systems employ either bilateral or multilateral netting methodologies. The netting of financial contracts through these systems and the finality of clearing and settlement through these systems should be recognized and protected upon the insolvency of one of the participants in the system in order to prevent systemic risk.

201. In many countries, the application of general insolvency rules will allow the financial contracts to be performed in accordance with their terms following commencement of insolvency proceedings by giving effect to contract termination clauses triggered by insolvency (see Part Two, Chapter III.D.2 and recommendation (53)) and by allowing for the set-off of obligations, whether a claim for breach is based on an automatic termination clause or arises pre-commencement. Other jurisdictions, with insolvency provisions that limit the effect of automatic termination clauses or that stay or limit the exercise of set-off rights and other creditor remedies, require specific exceptions in their insolvency laws to permit full enforcement of remedies in respect of financial contracts.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provision on netting and set-off in the context of financial transactions is:

- (a) To provide certainty with respect to the rights of parties to a financial contract when one of those parties fails to perform for reasons of insolvency;
- (b) To mitigate systemic risks that could threaten the stability of financial markets.

### **Content of legislative provisions**

(83) The law should recognize contractual termination rights associated with financial contracts that permit the termination of those contracts and the set-off and netting of outstanding obligations under those contracts promptly after the commencement of insolvency proceedings. Where the law stays the termination of contracts or limits the enforceability of automatic termination clauses on commencement of insolvency proceedings, financial contracts should be exempt from such limitations.<sup>4</sup>

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<sup>4</sup> This will allow market participants to extend credit based on “net” positions and make it impossible for the debtor to “cherry pick” contracts by performing some and breaching others,

(84) Once the financial contracts of the debtor have been terminated by a counterparty, the counterparty should be permitted to net or set-off obligations under those terminated financial contracts to establish a net exposure position relative to the debtor. This termination and set-off to establish a net exposure should be permitted regardless of whether the termination of the contracts occurs prior to or after the commencement of insolvency proceedings. Where the law limits or stays the exercise of set-off rights upon commencement of insolvency proceedings, set-off and netting of financial contracts should be exempt from such limitations.

(85) Once the financial contracts of the debtor have been terminated, counterparties should be permitted to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

(86) Routine pre-bankruptcy transfers consistent with market practice, such as the putting up of margin [to cover potential risk] for financial contracts<sup>5</sup> and transfers to settle financial contract obligations,<sup>6</sup> should be exempt from avoidance under applicable avoidance provisions of the insolvency law [without prejudice to the rules on fraudulent transactions].

(87) The insolvency law should recognize and protect the finality of the netting, clearing and settlement of financial contracts through [multilateral] payment and [securities] settlement systems upon the insolvency of a participant in the system.

(88) Recommendations (83) to (87) should apply to all transactions that are considered to be “financial contracts,” whether or not one of the counterparties is a financial institution.<sup>7</sup>

(89) Financial contracts should be defined broadly enough to encompass existing varieties of financial contracts and to accommodate new types of financial contracts as they appear.

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which is especially important with regard to financial contracts because of systemic risk.

<sup>5</sup> Margin is the process of posting additional cash or securities as a security for the transactions in accordance with a contractual formula that accounts for fluctuations in the market value of the contract and the existing security. For example, on a swap, a margin of 105 per cent might be required to maintain the termination value of the contract. If the security position falls to 100 per cent, an additional margin might be required to be posted.

<sup>6</sup> In some circumstances, a settlement payment might be viewed as a preference. In the example of a swap, settlement payments are to be made monthly or upon termination of the contract based on the market value of the contract. These payments are not value for value transfers, but rather payment of an accrued debt obligation that has matured. In countries that have a fixed suspect period for all transactions occurring before commencement, such a payment might also be subject to avoidance.

<sup>7</sup> Even if a given financial contract does not involve a financial institution, the impact of the insolvency of a counterparty could entail systemic risk.

**D. Report of the Working Group on Insolvency Law on the work of its  
thirtieth session (New York, 29 March – 2 April 2004)  
(A/CN.9/551) [Original: English]**

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## I. Introduction: Summary of the previous deliberations of the Working Group

1. The Commission, at its thirty-second session (1999), had before it a proposal by Australia (A/CN.9/462/Add.1) on possible future work in the area of insolvency law. That proposal had recommended that, in view of its universal membership, its previous successful work on cross-border insolvency and its established working relations with international organizations that have expertise and interest in the law of insolvency, the Commission was an appropriate forum for the discussion of insolvency law issues. The proposal urged that the Commission consider entrusting a working group with the development of a model law on corporate insolvency to foster and encourage the adoption of effective national corporate insolvency regimes.

2. Recognition was expressed in the Commission for the importance to all countries of strong insolvency regimes. The view was expressed that the type of insolvency regime that a country had adopted had become a “front-line” factor in international credit ratings. Concern was expressed, however, about the difficulties associated with work on an international level on insolvency legislation, which involved sensitive and potentially diverging socio-political choices. In view of those difficulties, the fear was expressed that the work might not be brought to a successful conclusion. It was said that a universally acceptable model law was in all likelihood not feasible and that any work needed to take a flexible approach that would leave options and policy choices open to States. While the Commission heard expressions of support for such flexibility, it was generally agreed that the Commission could not take a final decision on committing itself to establishing a working group to develop model legislation or another text without further study of the work already being undertaken by other organizations and consideration of the relevant issues.



3. To facilitate that further study, the Commission decided to convene an exploratory session of a working group to prepare a feasibility proposal for consideration by the Commission at its thirty-third session. That session of the Working Group was held in Vienna from 6 to 17 December 1999.
4. At its thirty-third session in 2000, the Commission noted the recommendation that the Working Group had made in its report (A/CN.9/469, paragraph 140) and gave the Group the mandate to prepare a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including consideration of out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches.<sup>1</sup>
5. It was agreed that in carrying out its task the Working Group should be mindful of the work under way or already completed by other organizations, including the World Bank, the International Monetary Fund (IMF), the Asian Development Bank (ADB), INSOL International (INSOL) (an international federation of insolvency professionals) and Committee J of the Section on Business Law of the International Bar Association (IBA). In order to obtain the views and benefit from the expertise of those organizations, the Secretariat, in cooperation with INSOL and IBA, organized the UNCITRAL/INSOL/IBA Global Insolvency Colloquium in Vienna from 4-6 December 2000.
6. At its thirty-fourth session in 2001, the Commission had before it the report of the Colloquium (A/CN.9/495).
7. The Commission took note of the report with satisfaction and commended the work accomplished so far, in particular the holding of the Global Insolvency Colloquium and the efforts of coordination with the work carried out by other international organizations in the area of insolvency law. The Commission discussed the recommendations of the Colloquium, in particular with respect to the form that the future work might take and interpretation of the mandate given to the Working Group by the Commission at its thirty-third session. The Commission confirmed that the mandate should be widely interpreted to ensure an appropriately flexible work product, which should take the form of a legislative guide. In order to avoid the legislative guide being too general or too abstract to provide the required guidance, the Commission suggested that the Working Group should bear in mind the need to be as specific as possible in developing its work. To that end, model legislative provisions, even if only addressing some of the issues to be included in the guide, should be included as far as possible.<sup>2</sup>
8. The twenty-fourth session of the Working Group on Insolvency Law (New York, 23 July-3 August 2001) commenced consideration of this work with the first draft of the legislative guide on insolvency law. The report of that meeting is contained in document A/CN.9/504. Work continued at the twenty-fifth (Vienna, 3-14 December 2001), twenty-sixth (New York, 13-17 May 2002) and twenty-

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<sup>1</sup> *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17)*, paras. 400-409.

<sup>2</sup> *Ibid.*, *Fifty-sixth Session, Supplement No. 17 (A/56/17)*, paras. 296-308.

seventh (Vienna, 9-13 December 2002) sessions of the Working Group. The reports of those meetings are contained in documents A/CN.9/507, A/CN.9/511 and A/CN.9/529 respectively.

9. At its twenty-seventh session, in response to a request by the Commission at its thirty-fifth session in 2002 that the Working Group make a recommendation as to the completion of its work,<sup>3</sup> the Working Group stressed the need to finalize the guide as soon as possible and recommended that while the draft guide may not be ready for final adoption by the Commission in 2003, nevertheless a draft should be presented to the Commission in 2003 for preliminary consideration and assessment of the policies on which the legislative guide was based. Such an approach would facilitate the use of the legislative guide as a reference tool before final adoption in 2004 and would allow those countries that have not participated in the Working Group an opportunity to consider the development of the guide. It was noted that the Working Group might require a further session in the second half of 2003 and possibly even the first half of 2004 to refine the text for final adoption.

10. At its twenty-eighth session (New York, 24-28 February 2003) the Working Group adopted the recommendation to the Commission that "After five sessions (between July 2001 and February 2003) of extensive study, analysis and deliberation, the Working Group advises the Commission that it has completed its review of the core substance of the draft legislative guide on insolvency law (as set forth in document A/CN.9/WG.V/WP.63 and Addenda 1-17) and recommends that the Commission:

"1. Approve the scope of the work undertaken by the Working Group as being responsive to the mandate given to the Working Group to prepare 'a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including consideration of out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features, including a discussion of the alternative approaches possible and the perceived benefits and detriments of such approaches';

"2. Give preliminary approval to the key objectives, general features and structure of insolvency regimes as set forth in the introductory chapters of Part One of the legislative guide;

"3. Direct the Secretariat to make the current draft of the legislative guide available to all United Nations member States, relevant intergovernmental and non-governmental international organizations, as well as the private sector and regional organizations for comment;

"4. Continue to work collaboratively with the World Bank and other organizations working in the field of insolvency law reform to ensure complementarity and avoid duplication and take into consideration the work of the Working Group VI on secured transactions; and

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<sup>3</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, para. 194.

“5. Direct the Working Group to complete its work on the legislative guide and present it to the Commission in 2004 for approval and adoption.”<sup>4</sup>

11. At its thirty-sixth session in 2003, the Commission considered the draft legislative guide and approved it in principle, subject to completion consistent with the key objectives. The Commission also requested the Secretariat to make the draft legislative guide available to Member States, relevant intergovernmental and non-governmental international organizations, as well as private sector and regional organizations and individual experts, for comment as soon as possible, and to present it to the Commission in 2004 for approval and adoption.<sup>5</sup>

12. Work on the draft legislative guide continued at the twenty-ninth session of the Working Group (Vienna, 1-5 September 2003). The report of that meeting is contained in document A/CN.9/542.

## II. Organization of the session

13. Working Group V (Insolvency Law) which was composed of all States members of the Commission, held its thirtieth session in New York from 29 March to 2 April 2004. The session was attended by representatives of the following States members of the Working Group: Austria, Brazil, Burkina Faso, Cameroon, Canada, China, Colombia, Fiji, France, Germany, India, Italy, Japan, Mexico, Romania, Singapore, Spain, Sudan, Sweden, Thailand, United Kingdom of Great Britain and Northern Ireland and United States of America.

14. The session was attended by observers from the following States: Australia, Belarus, Croatia, Cuba, Czech Republic, Denmark, Holy See, Ireland, Libyan Arab Jamahiriya, Madagascar, Mongolia, Netherlands, Nigeria, Philippines, Qatar, Republic of Korea, Saudi Arabia, Serbia and Montenegro, South Africa, Switzerland, Turkey, Venezuela and Viet Nam.

15. The session was also attended by observers from the following international organizations: (a) organizations of the United Nations system: International Monetary Fund (IMF), World Bank; (b) intergovernmental organizations: Asian-African Legal Consultative Organization, Asian Development Bank, Hague Conference on Private International Law, International Association of Insolvency Regulators (IAIR); (c) non-governmental organizations: American Bar Association (ABA), American Bar Foundation (ABF), Center for International Legal Studies (CILS), Centre pour la Recherche et l'Étude du Droit Africain Unifié (CREDAU), European Law Students Association, Groupe de Réflexion sur l'Insolvabilité et sa Prévention (GRIP 21), INSOL International, International Bar Association (IBA), International Insolvency Institute (III), International Law Institute (ILI), International Working Group on European Insolvency Law and Union Internationale des Avocats.

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<sup>4</sup> A/CN.9/530, para. 18.

<sup>5</sup> For the complete text of the Commission's consideration and decision see *Official Records of the General Assembly, Fifty-eighth Session, Supplement No. 17 (A/58/17)*, paras. 172-197.

16. The Working Group elected the following officers:
- Chairman:* Wisit WISITSORA-AT (Thailand)
- Rapporteur:* Jorge PINZÓN SÁNCHEZ (Colombia)
17. The Working Group had before it the draft Legislative Guide on Insolvency Law (A/CN.9/WG.V/WP.70, parts I and II); and a Note by the Secretariat: “Applicable law in insolvency proceedings” (A/CN.9/WG.V/WP.72).
18. The following background materials were also made available: Possible future work on insolvency law: Note by the Secretariat A/CN.9/WG.V/WP.50; Reports of the Secretary-General A/CN.9/WG.V/WP.54, A/CN.9/WG.V/WP.54/Add.1-2; A/CN.9/WG.V/WP.55; A/CN.9/WG.V/WP.57; A/CN.9/WG.V/WP.58; A/CN.9/WG.V/WP.59; A/CN.9/WG.V/WP.61 and Add.1; Report on the UNCITRAL/INSOL/IBA Global Insolvency Colloquium (2000) A/CN.9/495; Report of UNCITRAL on the work of its thirty-fourth session (2001) A/56/17; thirty-fifth session (2002) A/57/17; and thirty-sixth session (2003) A/58/17; Report of Working Group V (Insolvency Law) on the work of its twenty-second session (December 1999) A/CN.9/469; twenty-fourth session (July/August 2001) A/CN.9/504; twenty-fifth session (December 2001) A/CN.9/507; twenty-sixth session (May 2002) A/CN.9/511; twenty-seventh session (December 2002) A/CN.9/529; twenty-eighth session (February 2003) A/CN.9/530 and twenty-ninth session (September 2003) A/CN.9/542.
19. The Working Group adopted the following agenda:
1. Scheduling of meetings.
  2. Election of officers.
  3. Adoption of the agenda.
  4. Preparation of a legislative guide on insolvency law.
  5. Other business.
  6. Adoption of the report.

### III. Summary of deliberations and decisions

20. The Working Group reviewed the draft legislative guide on insolvency law commencing with applicable law in insolvency proceedings (A/CN.9/WG.V/WP.72) followed by document A/CN.9/WG.V/WP.70, part II and finally, part I. For lack of time the Working Group did not finalise its consideration of the Glossary in part one of the draft Guide, completing up to and including the term “related person”. The deliberations and decisions of the Working Group with respect to the various documents are set forth below. The Working Group’s deliberations were informed by the deliberations and conclusions of its joint session with Working Group VI (26 March 2004). The substance of paragraphs of the commentary and recommendations not specifically referred to in the report were found to be generally acceptable by the Working Group. Having completed its deliberations on the substantive parts of the Guide, the Working Group was of the view that approximately 5 to 6 days should be sufficient time for the Commission to finalize and adopt the draft Guide at its thirty-seventh session.

21. It was recalled that during its twenty-ninth session, the Working Group had considered a number of issues relating to coordination and harmonization of the draft UNCITRAL Legislative Guide on Insolvency Law with the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems. The Working Group noted a proposal to jointly publish the World Bank Principles and the finalized UNCITRAL Legislative Guide on Insolvency Law to prepare a unified standard on insolvency and creditor rights. That joint publication would include:

i. A section on the legal framework for insolvency, combining the World Bank's Principles with UNCITRAL's Legislative Guide (legislative recommendations and commentary). The section could also contain additional commentary prepared by the Bank if the additional commentary (a) dealt with aspects not covered by the UNCITRAL commentary, (b) was not inconsistent with the latter, and (c) clearly provided "value-added" material. Any perception of a "parallel commentary" was to be avoided.

ii. A section on institutional and regulatory frameworks, risk management, and informal workouts. The section would mainly incorporate the relevant sections of the World Bank's Principles together with related legislative recommendations and commentary currently being prepared by Bank staff, with the approach under (i) above to be followed for those subsections (mainly on certain regulatory framework issues) where UNCITRAL had legislative recommendations and commentary.

iii. A section on creditors rights and enforcement that would include the relevant sections of the World Bank's Principles and related recommendations and commentary (prepared by the Bank). In the case of the subsection(s) dealing with secured transactions issues, the unified standard would make clear that for the moment the standard in this area, unlike in other areas covered by the unified standard, included only the applicable World Bank Principles, and that the full standard would be completed at a later stage by incorporating the content of UNCITRAL's Legislative Guide on Secured Transactions, once it was finalized by UNCITRAL in 2005 or 2006.

22. Before finalization of the joint publication it was noted that the Chairman of the UNCITRAL Working Group on Insolvency Law, together with a group of experts and the secretariat of the Commission, would liaise with the World Bank with a view to ensuring the elimination of any potential inconsistencies between the UNCITRAL Legislative Guide and the World Bank Principles.

23. The Working Group supported that proposal, welcoming the coordination of work between the three organizations and the formulation of a joint publication, which would be of significant value to the field of insolvency law reform.

## **IV. Deliberations and decisions of the Working Group**

### **A. Applicable law in insolvency proceedings (A/CN.9/WG.V/WP.72)**

24. The Working Group noted that Working Group VI (Security Interests), at its fifth session (22-25 March 2004), found the principles contained in the current text of A/CN.9/WG.V/WP.72 to be generally acceptable (see A/CN.9/550, paragraph 34).

In particular, it was agreed that the commencement of insolvency proceedings should not displace the general, pre-insolvency conflict-of-laws rules applicable to the creation and effectiveness of a security right against third parties. It was further agreed that commencement of insolvency proceedings should not displace the law applicable to priority of security rights, except to the extent explicitly provided in insolvency law. However, it was also agreed that commencement could displace the rules applicable to the enforcement of security rights since enforcement should be subject to the insolvency law of the State in which the insolvency proceedings were commenced.

#### **Purpose clause**

25. With regard to the purpose section of the recommendations set forth in A/CN.9/WG.V/WP.72, it was suggested that an additional purpose of applicable law provisions in insolvency proceedings was to maximize the value of assets rather than to settle disputes between a debtor and its creditors. It was argued that that was important, as the effect of forum shopping would be to reduce the value of the estate. The general view of the Working Group, however, was that maximization of value of assets was better addressed as a principal objective of insolvency law as a whole, and that the current wording of the section should be retained.

#### **Recommendation 179**

26. While the Working Group generally approved the substance of recommendation 179 as drafted, strong support was expressed for locating the recommendation in a different chapter of the Guide, as it did not address issues of applicable law. Suggestions included: Part I.C, paragraph 28, outlining the general features of an insolvency law; and Part II, chapter V.A, in the introductory remarks concerning treatment of creditor claims. It was noted that, wherever placed, cross-references to the chapter on applicable law should be included. One drafting suggestion was to add the phrase “whether foreign or domestic” to recommendation 179 after the words, “under general law”.

#### **Recommendation 180**

27. The Working Group generally approved the substance of recommendation 180 as currently drafted. It was also agreed that the substance of the conclusions of Working Group VI (Security Interests), as noted above, should be included in the relevant part of the commentary in the chapter on applicable law.

#### **Recommendation 181**

28. Following discussion, broad support was expressed in the Working Group for retaining recommendation 181 as currently drafted, as opposed to moving subparagraphs (a)-(s) to the commentary. It was agreed, however, that some of the listed items, for the purposes of clarity, should be expanded. For example, it was suggested that the phrase, “that could be of prejudice to certain parties” be added to the end of subparagraph (g).

**Recommendation 182**

29. The Working Group agreed that the recommendation was essential to the chapter on applicable law and approved the substance of the text as currently drafted.

**Recommendation 183**

30. Several concerns were expressed as to the inclusion of recommendation 183 in the draft guide and as to its meaning. One concern was that, as a general principle, employees of the debtor working in the forum State should be treated according to the law of that State and that the words after “labour contracts” be amended to read “may be limited to employees in the State in which insolvency proceedings commence”. Another concern was that the recommendation should be revised to provide that only some contracts might be subject to another law or that the recommendation should only be relevant to labour contracts that were governed by law other than the law of the forum. A further concern was that, as currently drafted, the recommendation might give the impression that the Working Group favoured the inclusion of such an exception in an insolvency law and it should therefore be removed to the commentary. A different view was that since the provision was merely permissive and that in some regions of the world it was quite common for businesses to have employees working in different jurisdictions under different labour contracts, the recommendation should be maintained. It was noted that the absence of such an exclusion from the law of the forum might have public policy implications that had the potential to cause uncertainty and impede the conduct of insolvency proceedings. It was questioned whether the term “labour contracts” included both individual employment contracts and collective bargaining agreements. Responses to that question indicated that in some States it would include both, while in others only individual employment contracts. It was proposed that the commentary should address that question of definition. After discussion, the prevailing view was that recommendation 183 should be retained as drafted.

31. A proposal to include a further exception for rights *in rem* received some support, but after discussion, the prevailing view was that it should not be included. Some support was expressed for the view that rights *in rem* would already be covered by recommendation 180, and further explanation could be given in the commentary if required. It was also a matter of some concern that the Guide not be seen to encourage the proliferation of exceptions.

32. It was proposed that section D should be relocated to part two, chapter I, of the Guide.

**B. Draft legislative guide on insolvency law, part two  
(A/CN.9/WG.V/WP.70, part II)**

33. The Working Group commenced its consideration of document A/CN.9/WG.V/WP.70 with part two.

**1. Part two. Chapter I. Application and commencement**

34. It was observed that since in several States a “commercial” activity was one undertaken in the pursuit of profit, the term could not be used to describe a non-profit making enterprise, such as a charity or a public service organization. After some discussion, the Working Group agreed that the Guide should refer to debtors that engage in “economic”, rather than “commercial”, activities. This would enable such non-profit enterprises to be included in the scope of the Guide; it was noted that a key purpose of the Guide was to provide an insolvency law of broad application.

35. It was noted that several matters referred to in the recommendations were not discussed in the commentary, including the use of presumptions of insolvency mentioned in recommendation 11 (to which only a passing reference was made in paragraph 116) and debtors entitled to a discharge which was mentioned in recommendation 20, but not discussed in paragraphs 147-149. It was noted that since recommendation 20 referred to lack of assets as a ground for denial of the application, it should be aligned with recommendations 14 on denial and 21 on dismissal. It was also noted that, while the commentary currently addressed the provision of notice to foreign creditors with regard to the submission of claims, there was no specific discussion of the provision of notice to those creditors on the commencement of proceedings.

36. It was suggested that the Guide might provide greater guidance on issues arising in those States in which a long period might occur between the time of application and commencement of insolvency proceedings, including adjustment of the suspect period for avoidance actions, and treatment of creditor’s claims in that interim period. One response was that while further material might be added regarding the approach of different laws to those issues, it was not necessary for the Working Group to make any recommendations on either point. A further suggestion was that in the context of paragraphs 332-335 concerning the suspect period and chapter V.A on creditor claims, the Working Group could further consider those issues.

37. It was noted that while recommendation 145 addressed conversion of reorganization proceedings to liquidation, conversion from liquidation to reorganization was not discussed and a new recommendation, along the lines of recommendation 7 might be added to the effect that the insolvency law should address the question of conversion from one type of insolvency proceeding to the other. It was proposed that the following language be added to recommendation 13 (b) before the conjunction: “by contesting the application, consenting to the application or, where the application seeks liquidation, requesting the commencement of reorganization proceedings”. The Working Group approved the substance of the language proposed for addition to recommendation 13.

38. It was suggested that footnote 12 to paragraph 106 be corrected to note that the International Accounting Standards Board formulated international financial reporting standards rather than the GAAP accounting principles that were produced by the United States Financial Accounting Standards Board.

39. In response to a suggestion that the Guide should include specific recommendations on application by a government authority to commence insolvency proceedings, it was recalled that the Working Group had decided not to include such recommendations. A further suggestion to include a footnote to



recommendation 13 noting that the same procedure could apply to a public authority where it was not a creditor was not supported.

## **2. Part two. Chapter II. Treatment of assets on commencement of insolvency proceedings**

### **(a) Assets constituting the insolvency estate**

40. Following discussion, the Working Group agreed that recommendation 24 should be amended in the following manner: in the chapeau, replace “identify the assets that will constitute the estate, including” with “specify that the estate should include”; in subparagraph (a) delete the bracketed phrase “owned by the debtor” and the remainder of the subparagraph following the words “third party-owned assets”. It was suggested that footnote 28 to the recommendation be expanded to better explain the use of the term “assets” as discussed in the context of the joint session with Working Group VI (see document A/CN.9/550, paragraph 22). It was noted that recommendation 24 and the glossary would have to be aligned.

41. It was also agreed a new recommendation should be added to restate the text on timing deleted from recommendation 24, to the effect that the insolvency law should specify the date from which the estate was to be constituted, being either at the time of application for commencement or the effective date of commencement of insolvency proceedings. Support was also expressed for adding a cross-reference from recommendation 25 to chapter V.D on applicable law (A/CN.9/WG.V/WP.72).

42. It was noted that since many jurisdictions excluded damages from personal injury claims from the insolvency estate, an appropriate cross-reference might be made from paragraph 170 to the discussion of that point in footnote 25 to paragraph 157, and a footnote to that effect added to paragraph 174. It was noted that some States also excluded such things as monies received for public works from the estate.

### **(b) Protection and preservation of the insolvency estate**

43. Support was expressed in favour of adding, at the end of paragraph 197, a qualification to the effect that the court should only exercise the power to grant provisional measures if it was satisfied that the estate or assets of the debtor were at risk.

44. With respect to the recommendations, a proposal to retain, in recommendation 31, the words “upon urgent application” and “promptly” and delete alternative text in square brackets, was supported, as was a proposal to delete, in recommendation 38 (b), the text in square brackets to reflect the discussion and agreement in the joint session with Working Group VI (see A/CN.9/550, paragraph 17) on protection of value. A further proposal was to add the words “and application for commencement is dismissed” to the end of recommendation 33 to reflect a further situation in which provisional measures would terminate.

45. It was noted that the substance of recommendation 36, additional measures available on commencement of insolvency proceedings, was not discussed as such in the commentary, and the text of the commentary should be revised accordingly.

(c) **Use and disposal of assets**

46. A number of issues were raised with respect to the recommendations in section C. It was observed that the phrase “use or disposal” was used in addition to “sale”, but that forms of disposal other than sale were not addressed in recommendations 43-47, such as disposal by way of further encumbrance or by lease. To address other forms of disposal, particularly further encumbrance, it was proposed that text along the following lines be added: “The insolvency law should specify that assets subject to security interests may be further encumbered, subject to the requirements of recommendations 50, 51 and 52”. It was explained that those recommendations addressed the protections to be provided to secured creditors in the event of provision of post-commencement finance (chapter II.D) and were also relevant to the issue of further encumbrance. That proposal was supported.

47. It was also observed that although the estate included the debtor’s interest in third party owned assets (recommendation 24), the recommendations on use and disposal were limited in their application to the use and disposal of “assets of the estate”. It was questioned whether that issue was addressed in chapter II.E on contracts or whether more detail was required in chapter II.C to ensure the debtor could continue to exercise its rights with respect to third party owned assets. The following additional recommendation was proposed:

“The law should specify that the insolvency representative may use assets owned by third parties and in the possession of the debtor provided specified conditions are satisfied, including:

“(a) The interests of the third party will be protected against diminution in the value of the assets; and

“(b) The costs under the contract of continued performance of the contract will be paid as an expense of administering the estate.”

The Working Group adopted the substance of the proposed language.

48. In response to a suggestion that the phrase “assets of the estate” should be replaced with “assets of the debtor”, it was noted that the section on constitution of the insolvency estate included provision for certain assets of the debtor to be excluded from the estate in the case of natural person debtors and the phrase “assets of the debtor” was therefore too broad in the context of sale and disposal.

49. With respect to recommendation 41, it was observed that the reference to the right of creditors to object to a proposed sale was unrelated to the heading of the recommendation and may need to be separated from the recommendation. It was also suggested that the recommendation might need some redrafting to avoid the implication that objection by a creditor was sufficient to prevent the sale. Some support was expressed in favour of providing the creditor with the opportunity to be heard by the court on the proposed sale.

50. It was noted with respect to recommendation 42 that use of the word “publicized” might imply something different from a requirement for giving notice and that the text, both in the commentary and recommendations, should use these terms consistently.

51. The substance of the following revision of recommendations 41 and 42 was supported:

*Procedure for notification of disposal*

(41) The insolvency law should specify that adequate notice of any disposal conducted outside the ordinary course of business is given to creditors<sup>1</sup> and that they have the opportunity to be heard by the court.

(42) The insolvency law should specify that notification of public auctions is provided in a manner that will ensure the information is likely to come to the attention of interested parties.

Footnote<sup>1</sup> When the assets are encumbered assets or subject to other interests, recommendation (43) applies.

52. It was noted that as currently drafted, recommendation 44 appeared to repeat the content of other recommendations, specifically recommendation 40 (b), and could be deleted. To address the overlap of those recommendations, and to clarify the application of recommendation 43, it was proposed that recommendation 40 (b) should refer to recommendations 41 and 43; that the chapeau of recommendation 43 should read “The insolvency law should permit the insolvency representative to sell assets that are encumbered or subject to other interests free and clear of those encumbrances and other interests ...”; that recommendation 43 should apply only to sales outside the ordinary course of business; and that in order to confirm that subparagraphs (a) to (d) of recommendation 43 should apply cumulatively, the word “and” be added after subparagraph (c). That proposal received support.

53. It was recalled that the joint session had discussed the issue of retention of title (see A/CN.9/550, paragraphs 21-22) and in order to give effect to the conclusions reached, it was proposed that some additional material should be added to paragraphs 236 and 237 to clarify the ability of the estate to continue to use those assets.

54. With respect to cash proceeds, it was proposed that paragraph 238 should also refer to non-cash proceeds of sale and that recommendation 43 (d) should be amended to recognize ongoing priority rights where property was purchased with the proceeds of sale of an asset, such as where inventory was sold and further inventory purchased with the proceeds. Support was expressed in favour of including recommendations on cash proceeds. It was proposed that recommendation 40 (a) be revised to provide for the use and disposal of assets of the estate (including assets subject to security interests) in the ordinary course of business except cash proceeds, with an additional recommendation along the following lines:

“The law should specify that, where the secured creditor does not agree, the court may authorize the use of cash proceeds provided specified conditions are satisfied, including:

“(a) The secured creditor was given the opportunity to be heard by the court;

“(b) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.”

55. The Working Group adopted the proposal with respect to recommendation 40 (a) and the substance of the language proposed as a new recommendation.

56. It was further suggested that the term “cash proceeds” be added to the glossary with a definition along the lines of “proceeds, if subject to a security interest, of the sale of encumbered assets”. That proposal was supported. It was suggested that the commentary should make it clear that what was being discussed was the proceeds that arose out of the sale of encumbered assets, and not the proceeds of the sale of any assets.

57. It was noted that recommendation 137 may have been rendered redundant by the changes proposed to the section on use and disposal of assets, but that it would need to be reconsidered in the context of reorganization.

58. With respect to recommendation 48 and paragraph 234, it was proposed that the commentary should address the question of to whom assets could be relinquished, particularly in the case of land. It was also suggested that further clarification might be required with respect to valuation of the relinquished asset in order to determine the value of any associated claim by the creditor.

**(d) Post-commencement finance**

59. The Working Group acknowledged the importance of providing sufficient incentives for the provision of new finance and it was proposed that additional language be added to recommendation 49 to reflect that importance.

60. It was proposed that recommendation 52 should be permissive only, so that the insolvency law “may” include provisions for that type of priority. After discussion, it was agreed that the word “should” would be retained. It was observed that as the concept of “unreasonable risk” created difficulty in some legal systems, the words after “protected” should be deleted.

61. It was noted that there was some inconsistency between the recommendations and the discussion in the commentary on the provision of a security interest as opposed to the provision of priority and it was suggested that the text should be aligned. It was also suggested that the discussion should focus on the provision of priority, since that was more prevalent than providing a security interest.

**(e) Treatment of contracts**

62. Regarding recommendation 56, it was agreed that the words “on the commencement of insolvency proceedings” be deleted from the chapeau to remove any implication that the recommendation did not apply in the period between an application for commencement and commencement. With respect to subparagraphs (a) and (b), the suggestion was made that the paragraphs should focus on the event of insolvency, rather than upon application or commencement. Further suggestions included adding the words “or accelerates”, following “terminates” in the chapeau and adding a subparagraph (c), “the entry of an order seeking conversion of a liquidation proceeding to a reorganization proceeding”. While different views were expressed regarding the strength of the direction to be given by the recommendation, and whether “may” or “should” should be used, it was agreed, after discussion, that the provision would remain as drafted. It was observed that where a party was required or continued to perform a contract after commencement, the benefits derived from continued performance should be paid for by the estate, and it was noted that that issue was addressed in part by recommendations 65 and 67, which required some redrafting.

63. It was suggested that the square bracketed language in recommendation 62 might be deleted.

64. With respect to recommendation 65, it was suggested that clarification was required as to whether subparagraph (a) would include both pre-commencement and post-commencement breach and whether the meaning of “is able to perform” in subparagraph (b) included the ability to continue to pay for services provided. The Working Group considered a proposal for redrafting recommendations 65 to 67 as follows:

*Continuation of contracts where the debtor is in breach*

(65) The law should specify that where the debtor is in breach under a contract the insolvency representative can continue the performance of that contract, provided the breach is cured, the non-breaching counterparty is substantially returned to the economic position it was in before the breach, and the estate is able to perform under the continued contract.

*(65)(b) deleted*

*Performance prior to continuation or rejection*

(66) The law should specify that the insolvency representative may accept [or require] performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted [or required] by the insolvency representative prior to continuation or rejection of the contract should be payable as an expense of administering the estate:

(a) if the counterparty has performed the contract to the benefit of the estate, the benefits conferred upon the estate, pursuant to the terms of the contract, are payable as an administrative expense.

(b) if the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that third party should be protected against diminution of the value of those assets and the cost under the contract of continued performance of the contract should be treated in accordance with paragraph (a).

(67) The law should specify that where a decision is made to continue performance of a contract, damages for the subsequent breach of that contract should be payable as an administrative expense.

65. It was proposed that paragraph 278 precede paragraph 277 under the heading “Performance prior to continuation or rejection”, with the addition of the following text to the end of paragraph 278:

“Where the insolvency representative determines that a contract should be performed prior to a determination to continue or reject, the insolvency representative should be able to accept or require performance from the counterparty. As a condition to accepting or requiring performance, the costs under the contract of costs under the contract of continued performance should be payable as expenses of administering the estate. If the insolvency representative uses assets owned by a third party that are in the possession of

the debtor subject to contract, that party should be protected against erosion of the value of those assets and the costs under the contract of the benefits conferred on the estate by the use of those assets should be payable as an administrative expense.”

66. The Working Group approved the substance of the revision proposed for recommendations 65 to 67, together with the proposed commentary.

67. It was suggested that a new subparagraph (d) might be added to recommendation 70 to the effect that defaults should be cured before the assignment as part of the conditions of the assignment. It was queried whether that proposal would be limited to post-commencement default, or also include pre-commencement default.

68. Support was expressed for adding at the end of recommendation 71 the words: “and the estate will have no further liability under the contract”.

**(f) Avoidance proceedings**

69. It was questioned whether the Working Group should retain the requirement for knowledge of the debtor’s intent in recommendation 73 (a), on the basis that to do so would set a very high standard that would be difficult to prove. It was agreed, following discussion, that the paragraph should focus on the effect of the transactions on creditors and, accordingly, that the opening phrase of the paragraph should be “transactions with the effect of defeating, delaying or hindering the ability of creditors ...”, and that the final phrase should be “or otherwise prejudice the interests of creditors” with the words, “and where the counterparty knew or should have known of the debtor’s intent”, being deleted.

70. It was further suggested that there appeared to be a gap in recommendation 73 (b) as it made no reference to gifts that would also be considered to be within this category of transaction.

71. Concern was expressed that although the commentary to the Guide discussed various approaches to the length of the suspect period, sufficient guidance on the desirability of adopting short periods was not provided in recommendation 75. In particular, it was proposed that the recommendations should include reference to specific periods—in the case of transactions in recommendation 73 (a), perhaps 1 to 2 years and for those in 73 (b) and (c), perhaps 6 months to 1 year. While there was some support for including more specific references to possible time periods, it was generally agreed that more discussion of the need for shorter periods and the supporting reasons should be added to the commentary.

72. Several observations were made with respect to subparagraphs (b) and (c) of recommendation 76. Firstly, it was suggested that those provisions should not be limited in their application to related person transactions but could be applicable more generally. Another observation was that the distinction between those two paragraphs was not clear, although it was also observed that a presumption under subparagraph (b) could be challenged, while subparagraph (c) established a rule of procedure that could not. After discussion, there was some support for removing subparagraphs (b) and (c) from recommendation 76 and redrafting them to be of more general application as evidentiary provisions.

73. It was agreed that in the second sentence of recommendation 81 the text in square brackets should be retained without the brackets. The question was raised, however, as to whether that text should apply to all of recommendation 73 or simply subparagraph (a). One view was that only the transactions described in subparagraph (a) should be excepted from the general rule that the suspect period applied retrospectively from commencement. A different view was that the concern with concealed transactions might apply equally to all of the transactions described in recommendation 73. Support was expressed in favour of both views, but after discussion it was agreed that the reference to subparagraph (a) should be deleted so that the exception would apply to all of the transactions described in recommendation 73. It was also suggested that the recommendation should include more specific reference to the time period within which avoidance proceedings could be commenced, for example 2 years, in order to ensure that those proceedings were not taken many years after the transactions in question. It was agreed that more specific discussion should be included in the commentary.

74. In response to a question about the effect of avoided transactions, reference was made to paragraphs 330-31 of the commentary and to a previous agreement not to include recommendations on that point.

75. With respect to recommendation 80, it was agreed that in addition to the current text, the recommendation should establish a general principle that the costs of avoidance proceedings should be paid from the estate.

**(g) Set-off, financial contracts and netting**

76. Although the view was expressed that a general right of set-off should only be available in very limited circumstances, the text of recommendation 85 as drafted received support.

77. With respect to recommendation 92, it was agreed that the text in square brackets should be retained without the brackets on the basis that it clarified the scope of the provisions. In that regard, the suggestion that it might be more appropriate to include that text in the purpose provision than as a specific recommendation received some support.

78. Concern was expressed as to the uncertainty created by the absence of guidance on the scope of the term “financial contact”. It was noted that a definition was included in the glossary to the Guide, although in square brackets. It was also observed that the types of contracts to be included in the provisions on financial contract were generally well recognized in the financial world and that the need for flexibility made reaching a definition of such contracts difficult.

**3. Part two. Chapter III. Participants**

**(a) The debtor**

79. In response to a concern that where information was to be provided by a legal person debtor it should include information as to possible future liabilities of the debtor, it was generally agreed that that would be covered by the term “business affairs” in recommendation 95 (b) and by the reference to the provision of information regarding the types of proceedings affecting the debtor in subparagraph (b) (ii). For clarification, it was proposed that subparagraph (b) (v) be

redrafted along the lines of “creditors and their claims, prepared in cooperation with the insolvency representative and revised and amended by the debtor as claims are verified and admitted or denied”. Although some concern was expressed as to the usefulness of retaining the word “reasonably” in paragraph (b) it was agreed that in order to avoid vexatious and unjustified requests, especially by creditors, the retention of that term might prove helpful.

80. It was agreed that the opening phrase in square brackets of recommendation 95 (c) should be deleted and the words “to cooperate” added. It was noted that some of the material included in paragraph 376 of the commentary was not applicable only to debtors in possession and should be removed. As a general matter, it was suggested that the Guide should make it clear, both in the commentary and the recommendations, that whenever an insolvency law provided for a debtor in possession, that debtor generally should have the same powers and functions as an insolvency representative. To address that concern, it was proposed that a further recommendation be added after recommendation 97 to the effect that the law should specify that a debtor in possession would have the powers and functions of an insolvency representative, except for the right to remuneration.

**(b) The insolvency representative**

81. A proposal that the Guide should place more emphasis on the use of independent agencies to select, appoint and supervise the insolvency representative was noted, but not supported on the basis that many countries were not necessarily in a position to establish such agencies and therefore the inclusion of such recommendations was not desirable.

82. It was agreed that paragraph 400 of the commentary should specify that the insolvency representative should not have a criminal record.

83. It was proposed that the reference to liability in recommendation 105 was too broad and that the final phrase should be “and any related standard of liability imposed.”

**(c) Creditors—participation in insolvency proceedings**

84. The Working Group agreed to replace the italicized wording in recommendation 112 with the phrase “a specific percentage of the total value of”, noting that the requirement varied significantly between States. It also agreed to delete the bracketed language in recommendation 115.

85. It was agreed that, while the substance of the recommendations was largely acceptable, some redrafting of the section might be necessary to ensure that while the commentary should clearly express the preference of the Working Group for the setting up of creditor committees, it should be noted that other forms of representation and consultation of creditors existed that worked successfully in some States. It was noted that, accordingly, some revision of recommendation 113 might be necessary. The observation was made that where a regime relied upon creditor committees, the insolvency law should ensure that such arrangements respected the rights of all creditors. In discussing the role of creditor committees and creditor meetings, it was noted that the two subjects raised different issues. It was remarked, however, that the purpose of creditor interaction in relation to any particular issue would decide the appropriate creditor forum. The voting



requirements of reorganization, for example, would determine whether a meeting of all creditors would be required or whether a smaller representative group might act. There was general agreement that the representation of rights had to be balanced with the need for timely and efficient conduct of the proceedings.

86. Support was expressed for ensuring that the commentary addressed the right of foreign creditors to fully participate in proceedings, noting the discussion of the principle of equal treatment of foreign and domestic creditors in chapter V.A, on the treatment of creditor claims.

**(d) Party in interest's right to be heard and to appeal**

87. With regard to a suggestion to add to the rights of creditor committees the right to be heard in the proceedings in recommendation 117 in the preceding section, it was noted that a creditor committee was defined in the glossary as a party in interest, and, as such, was covered by recommendations 121 and 122.

**4. Part two. Chapter IV. Reorganization**

**(a) The reorganization plan**

88. While the Working Group expressed general satisfaction with the substantive policy of the section, it was agreed that some redrafting of the recommendations would give clearer effect to the discussion of the relevant issues in the commentary and strengthen the Guide overall.

89. It was suggested that the following propositions should guide a revision of the recommendations: (a) to the extent that reorganization included secured creditors, the insolvency law should provide a number of safeguards to protect against inter-creditor discrimination; (b) if a creditor was to be bound by a reorganization plan without its consent, it should have the right to vote in the proceedings; (c) if secured or priority creditors were bound by a plan, those creditors should vote on the plan as a separate class; (d) a creditor in a particular class should receive the same terms as all other creditors in that class and to the extent that differing treatment of creditors could maximize the success of a reorganization plan, different classes of unsecured creditors should be created; (e) dissenting creditors in an approving class should receive at least as much as they would have received in liquidation proceedings; and (g) a dissenting class of creditors should receive at least as much as that class would have received in liquidation proceedings, relative to their particular class interests.

90. The Secretariat was requested to prepare a redraft of the recommendations based upon those observations. The Working Group also agreed that the following changes be incorporated in that revision: (a) to retain the bracketed language, but not the brackets, in recommendation 128 (b)(i); (b) to retain recommendation 135, as currently drafted, but noting that it was closely connected to recommendation 145(c), to move recommendation 135 to follow recommendation 144; (c) to amend the references in recommendation 139 (a) and (b) to refer to recommendations 138 and 140 respectively.

91. A number of further drafting amendments were also suggested: (a) to include equity holders in the list of parties in recommendation 125 (b) who might propose a plan; (b) to merge recommendations 126 and 127 under the heading "Preparation and submission of a disclosure statement"; (c) to add the phrase "and retention of

title arrangements” to the end of recommendation 128 (b)(ii); (d) to delete the word “statements” from recommendation 129 (a); (e) to add a new subparagraph to recommendation 129 requiring the inclusion in the disclosure statement of any supplementary non-financial information that might impact on the future performance of the debtor (e.g. the availability of a new patent); (f) to include in recommendation 129 a reference to the obligations of confidentiality established in chapter III; (g) that recommendation 130 be expanded to detail the classes that may vote on the plan; (h) that recommendation 133 be modified to state that where there are distinct classes of creditors, creditors should vote in classes; (i) to amend recommendation 138 (b) to reflect the idea that no one creditor should be particularly prejudiced compared to all other creditors within its class; (j) that the words “with regard to each respective class” be inserted in recommendation 138 (c), following “creditors”; (k) to clarify whether footnote 94 to recommendation 138 (f) referred to agreement by a class or individual creditors; (l) to add the words “or dismissal” before “where” in the chapeau to recommendation 145; (m) that it should be made clear that conversion was appropriate where the breach of the terms of the plan was by the debtor, but not where the breach was attributable to a third party; and (n) with regard to paragraph 522, the debtor might be allowed to vote on the plan in defined circumstances.

92. Different views were expressed regarding the need for recommendation 128 (c)(vi), but no decision as to retention or deletion was taken by the Working Group.

93. There was some support for the introduction of a new recommendation based on paragraph 539 of the commentary to the effect that the court should not be asked to review the economic and commercial basis of creditors decisions, or the economic feasibility of a reorganization plan. In response, it was observed that these were normal tasks regularly undertaken by courts in some jurisdictions and it was agreed that no recommendation should be included.

**(b) Expedited reorganization**

94. Concern was expressed that the expedited section was not sufficiently clear as to the goal of those types of proceedings, nor as to the relationship of expedited proceedings to full reorganization proceedings discussed in section A of chapter IV and elsewhere in the Guide, or the scope of such proceedings. Although a suggestion was made to place the section in an annex to the draft Guide, the prevailing view was that it should remain as part of chapter IV of the Guide. However, to facilitate understanding of the chapter and more clearly explain the purpose and scope of expedited proceedings, it was proposed that the commentary should be redrafted to include more explanatory material and that it should more closely follow the content of the recommendations.

95. With respect to recommendation 146 (a), various views were expressed as to the appropriate commencement conditions that should apply. One view was that a debtor should not have to be eligible to commence proceedings under the insolvency law in order to commence expedited proceedings, although it was noted that the proceedings could be used by any debtor eligible under the reorganization law. Another view, which received support, was that both texts in square brackets could be deleted, so that expedited proceedings would be available to debtors that were

likely to be generally unable to pay their debts as they matured. It was agreed that the language in square brackets in subparagraph (b) could be deleted.

96. It was suggested that as the treatment noted in subparagraph (e) of recommendation 147 would be included within the plan and disclosure statement in subparagraph (a) and also in subparagraph (d), subparagraph (e) could therefore be deleted.

97. With respect to recommendation 150, it was proposed that the requirement to provide individual notice, especially to equity holders and bond holders, could be especially burdensome and it was agreed that it would be sufficient if notice was to be communicated using existing available means. It was also noted that the requirement to provide notice to equity holders was not included in other notice provisions in the Guide.

98. It was queried how the requirement for court confirmation of an expedited plan in recommendation 151 could be reconciled with the optional nature of confirmation in section A of chapter IV, and suggested that more discussion might be required in the commentary.

99. After discussion, it was agreed that the first text in square brackets in recommendation 153 be retained and the second deleted. With respect to other text set forth in square brackets in the recommendations, the Working Group agreed that in recommendation 147 (b) that text should be deleted; in recommendation 149 (b) it should be retained; and in recommendation 151 (b) it should be retained.

## **5. Part two. Chapter V. Management of proceedings**

### **(a) Creditor claims**

100. It was agreed that recommendation 154 should be revised to require only those creditors who wanted to participate in the proceedings to file their claims. It was also proposed that claims should be allowed to be submitted by different means.

101. With respect to secured creditors, it was proposed that recommendation 156 should require them to submit claims and that they should be submitted under recommendation 154 or 158 at an early stage of the proceedings, to facilitate the conduct and administration of the proceedings. It was suggested that recommendation 159 should follow or be merged with recommendation 154.

102. It was agreed that the text in recommendation 160 in square brackets should be deleted and that the concept of providing special measures for both currency instability and currency fluctuations be explained in the commentary.

103. It was also agreed that the text in square brackets in recommendations 163, 166 and 167 should be retained and that issues arising from recommendations 166 and 167 should be subject to review under recommendation 163. No support was expressed in favour of a proposal to include disallowance in recommendation 168 (c). It was noted that recommendation 169 should be read in conjunction with recommendations 162 and 163.

### **(b) Priorities and distribution**

104. A proposal to add the words “classes of” before the word “claims”, and the words “if any” after the word “claims” in recommendation 172 was supported. It

was noted that the reference to subordinated claims should only encompass the concept of equitable subordination as contractual subordination could result in claims being treated at different levels of priority, depending upon the agreement.

**(c) Corporate groups**

105. The Working Group generally approved the substance of revisions to section C as follows:

644. Three issues of specific concern in insolvency proceedings involving one of a group of companies are:

(a) Whether any other company in the group will be responsible for the external debts of the insolvent company (being all debts owed by the insolvent company except for those owed to related group companies, i.e. “intra-group debts”); and

(b) Treatment of intra-group debts (claims against the debtor company by related group companies).

(c) Commencement of insolvency proceedings by a group company against a related group company.

Amend the first sentence of paragraph 645 as follows:

645. Reflecting the complexity of this topic, insolvency laws provide different responses to these and other issues which may be distinguished by the extent to which a law allows the veil of incorporation to be lifted.

Add the following text as a new paragraph after paragraph 645:

Although a variety of approaches are taken to these very complex issues, it is important that an insolvency regime address matters concerning corporate groups in sufficient procedural detail to provide certainty for all parties concerned in commercial transactions with corporate groups. Alternatives to direct regulation of corporate groups in insolvency would include providing sufficient definition in other parts of the insolvency law to allow application of those provisions to corporate groups, such as the use of avoidance or subordination provisions with respect to related parties.

106. It was also proposed that a reference to the applicable law chapter could appropriately be added to section C.

**6. Conclusion of proceedings**

**(a) Discharge**

107. It was suggested the commentary should include a statement to the effect that discharge of the debtor should not affect the liabilities of a third party that has guaranteed the obligations of the debtor.

108. With respect to the provision of discharge, it was proposed that the commentary should draw a clear distinction between providing that discharge and imposing conditions on the debtor that would nevertheless limit its rehabilitation. It was noted, for example, that under some laws a discharged debtor was not permitted to undertake commercial activity.

**(b) Conclusion of proceedings**

109. A proposal to revise both recommendations 186 and 187 to provide that the law should specify the procedures by which both liquidation and reorganization proceedings should be closed was supported. Specifying who could apply, whether the application for closure and the decision to close might be publicized and whether creditors could be heard were noted as being relevant to that procedure. It was also proposed that recommendation 187 should address the situation where implementation of the plan failed or it was determined to be incapable of implementation. It was noted that amendment of the plan might also be relevant in such cases.

**C. Draft legislative guide on insolvency law, part one**

110. Support was expressed in favour of a proposal to include a set of recommendations addressing the key objectives and to locate other recommendations of a general nature, such as recommendations 7 and 179, in part one of the draft guide. The Working Group agreed that the recommendations along the following lines be added to the text.

111. Following paragraph 22 of the commentary (where subparagraphs (a)-(h) of the recommendation reflect the statement of key objectives set forth in paragraphs 12-22 of A/CN.9/WG.V/WP.70, part I):

“(1) In order to establish and develop an effective insolvency law, the following key objectives should be considered:

“(a) Provide certainty in the market to promote economic stability and growth;

“(b) Maximize value of assets;

“(c) Strike a balance between liquidation and reorganization;

“(d) Ensure equitable treatment of similarly situated creditors;

“(e) Provide for timely, efficient and impartial resolution of insolvency;

“(f) Preserve the insolvency estate to allow equitable distribution to creditors;

“(g) Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; and

“(h) Recognize existing creditors rights and establish clear rules for ranking of priority claims.”

112. Following paragraph 27 of the commentary:

“(2) The recommendations in the Legislative Guide have been designed to address each of the key objectives and achieve an appropriate balance between them.”

113. Following paragraph 30 of the commentary (where subparagraphs (a)-(n) reflect the substance of paragraph 28 of A/CN.9/WG.V/WP.70, part I):

“(3) In order to design an effective and efficient insolvency law, the following common features should be considered:

“(a) Identifying the debtors that may be subject to insolvency proceedings, including those debtors that may require a special insolvency regime;

“(b) Determining when insolvency proceedings may be commenced and the type of proceeding that may be commenced, the party that may request commencement and whether the commencement criteria should differ depending upon the party requesting commencement;

“(c) The extent to which the debtor should be allowed to retain control of the business once insolvency proceedings commence, or be displaced and an independent party (in the Guide referred to as the insolvency representative) appointed to supervise and manage the debtor, and the distinction to be made between liquidation and reorganization in that regard;

“(d) Protection of the assets of the debtor against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

“(e) The manner in which the insolvency representative may deal with contract entered into by the debtor before the commencement of proceedings and in respect of which both the debtor and its counterparty have not fully performed their respective obligations;

“(f) The extent to which setoff or netting rights can be enforced or will be protected, notwithstanding the commencement of insolvency proceedings;

“(g) The manner in which the insolvency representative may use or dispose of assets of the insolvency estate;

“(h) The extent to which the insolvency representative can avoid certain types of transactions that result in the interests of creditors being prejudiced;

“(i) In the case of reorganization, preparation of the reorganization plan and the limitations, if any, that will be imposed on the content of the plan, the preparer of the plan and the conditions required for its approval and implementation;

“(j) The ranking of creditors for the purposes of distributing the proceeds of liquidation;

“(k) Implementation of the reorganization plan;

“(l) Distribution of the proceeds of liquidation;

“(m) Discharge or dissolution of the debtor in liquidation; and

“(n) Conclusion of the proceedings.”

114. The Working Group strongly supported a proposal to include the text of the UNCITRAL Model Law on Cross-Border Insolvency and the Guide to Enactment together with the draft guide, stressing the need for countries to address not only

domestic insolvency law reform, but also issues of cross-border insolvency. Given the different nature of the two texts, however, it was agreed that the Model Law should perhaps be included as an annex to the draft guide to avoid any confusion as to how the two different types of texts might be used or adopted by States. It was noted that those issues could be addressed in the introduction to the draft guide, and that the draft Guide should retain the appropriate cross-references to the Model Law and Guide to Enactment. It was also proposed that the Guide should strongly recommend the adoption of the UNCITRAL Model Law.

115. A number of suggestions were made with respect to the organization of the material in part one, including integrating the introduction in part one more closely to the substance of part two by including appropriate cross-references; underlining the Guide's focus on debtors engaged in economic activity, rather than consumer debtors; reorganizing paragraphs 28-30 closer to paragraphs 65-69; adding an introductory paragraph to section II of part one, to explain in particular the reason for including the material on administrative procedures; and adding to section III information on work being done by international organizations on strengthening institutional infrastructure. It was noted that the reference to the Bank of England guidelines in paragraph 46 required some clarification and that the Secretariat would revise paragraphs 58 and 59 in light of the conclusions on chapter IV, section B, and include the revised explanation of expedited reorganization proceedings under the heading "Reorganization proceedings".

116. As a matter of drafting, the Secretariat was requested to consider whether the phrase "overall goal" was appropriate in the last sentence of paragraph 12 and whether the last sentence of paragraph 13 should be added to paragraph 14; and to add words along the lines of "preserving the value of the enterprise" to the second sentence of paragraph 14.

## **D. Glossary**

117. The Working Group requested the Secretariat to reorganize the glossary to facilitate comparison between the official language versions.

### **Administrative claim or expense**

118. It was agreed that the current drafting of the term should be retained with the deletion of the word "proper", qualifying the insolvency representative's exercise of its functions. A further amendment suggested was to refer to legal as well as contractual obligations.

### **Application for commencement of insolvency proceedings**

119. The Working Group agreed to delete the term from the glossary.

### **Avoidance provisions**

120. The Working Group considered the following revised definition:

"Provisions of the insolvency law 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 such assets transferred or their value to be recovered in the collective interests of creditors or the

insolvency estate if the transactions meet criteria specified in the insolvency law.”

121. Adoption of that revision with the deletion of the final clause “if the transactions meet criteria specified in the insolvency law” was agreed.

#### **Assets of the debtor**

122. The substance of the text as drafted was supported.

#### **Burdensome assets**

123. It was agreed that the words “for example” be replaced with “or”, and the text as drafted be adopted.

#### **Centre of main interests**

124. The Working Group approved the substance of the text as drafted.

#### **Claim**

125. The Working Group considered a proposal to revise the text as follows:

“A right to payment from the estate of the debtor, whether arising from a debt, a contract or other theory of legal obligation, whether liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, fixed or contingent.

Note: Some jurisdictions recognize the ability or right, where permitted by applicable law, to recover [assets][goods] from the debtor as a claim.”

126. That proposal received some support, but for lack of time the Working Group was unable to complete its consideration of the term.

#### **Commencement of proceedings**

127. The Working Group considered a proposal to revise the text as follows:

“The event determining the effective date of insolvency proceedings whether established by statute or a judicial decision.”

128. That proposal received some support, but for lack of time the Working Group was unable to complete its consideration of the term.

#### **Creditor**

129. The Working Group considered a proposal to add the following text:

“A natural or legal person which has a claim against the debtor that arose on or before the commencement of the insolvency proceedings.”

130. Although there was some support for not adding the term to the glossary, it was agreed that since it was closely related to the term “claim”, it should perhaps be revisited when that term was resolved.



**Creditor committee**

131. The Working Group approved the substance of the definition with the addition of the words “of creditors” to describe the representative body.

**Debtor**

132. Deletion of the term “debtor” from the glossary was supported.

**Discharge**

133. The Working Group adopted the text as drafted, substituting “claims” for “liabilities”.

**Disposal**

134. The Working Group adopted the text as drafted.

**Encumbered asset**

135. The Working Group adopted the text as currently drafted, but requested the Secretariat to review the Guide to ensure consistent use of the phrase “other interests”, being interests held by a third party, such as co-ownership, that were broader than security interests.

**Equity holder**

136. The Working Group adopted the following definition of equity holder:

“The holder of issued stock or a similar interest that represents an ownership claim to a proportion of the capital of a corporation or other enterprise.”

**Establishment**

137. The text as drafted was adopted by the Working Group, with the bracketed language to be placed in a footnote.

**Estate**

138. It was agreed to delete the cross-reference to “insolvency estate”.

**Financial contract**

139. The current drafting of the text was adopted by the Working Group, with the reference to the origin of the text to be placed in a footnote. It was noted that the wording had been deliberately framed in a general and open-ended way to provide the necessary flexibility to capture what were rapidly-evolving instruments or arrangements, which would still provide guidance to users of the Guide by clearly indicating the intention of what the term should encompass. It was stated that the purpose of giving guidance as to the usage of the term in the draft Guide was to provide some certainty as to the scope of the subject matter to be excluded from the ambit of the normal insolvency regime, in the interests of avoiding systemic risk to the financial markets. It was suggested that the Guide might note that purpose to ensure users were fully aware of the underlying intention of the draft Guide.

**Government authority**

140. The Working Group agreed to delete the term from the glossary.

**Insolvency**

141. The substance of the text was approved as currently drafted.

**Insolvency estate**

142. The Working Group agreed that the text should be shortened to “assets of the debtor subject to the insolvency proceedings”.

**Illiquidity**

143. It was proposed that the Guide include of the term “illiquidity”, or incapacity to pay debts, as it was a term known to many countries. After discussion, it was agreed that the underlying concept was encompassed in the Guide’s discussion of the commencement standard for insolvency proceedings, and that an additional term was not necessary.

**Insolvency proceedings**

144. The Working Group supported the substance of the following revised text:

“Collective proceedings, subject to court supervision, either for reorganization or liquidation”.

**Insolvency representative**

145. The Working Group agreed to adopt the definition “foreign representative” used in UNCITRAL Model Law on Cross-Border Insolvency with appropriate amendments, along lines of, “person or body, including one appointed on an interim basis, authorized in an insolvency proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs”.

**Liquidation**

146. The Working Group supported the substance of the following revised text:

“Proceedings to sell and dispose of assets for distribution to creditors in accordance with the insolvency law”.

**Lex fori concursus**

147. The Working Group agreed to add the following term to the glossary:

“*Lex fori concursus*”: the law of the State in which the insolvency proceedings are commenced.

**Lex rei situs**

148. The Working Group agreed to add the following term to the glossary:

“*Lex rei situs*”: the law of the State in which the asset is situated.

**Netting**

149. The Working Group adopted the following proposal for drafting of the term, but did not reach agreement on a final text:

“The setting-off of [mutual] monetary or non-monetary obligations [between parties to] [under] financial contracts.”

**Netting agreement**

150. The Working Group approved the current drafting with the opening words “an agreement”, to be replaced with “a form of financial contract”.

**Ordinary course of business**

151. The following revised text was proposed but for lack of time was not considered by the Working Group:

“Transactions consistent with both (i) the operation of the debtor’s business prior to insolvency proceedings; and (ii) ordinary business terms.”

**Pari passu**

152. The Working Group considered the following proposal for amendment of the text:

“The principle according to which similarly situated creditors are treated proportionately to their claim and are satisfied proportionately out of the assets of the estate available for distribution to creditors of their rank.”

153. The Working Group adopted the text with the deletion of the words, “proportionately to their claim” and addition of the words “to their claim” before “out of the assets”.

**Party in interest**

154. The Working Group agreed that the text should be redrafted along the following lines:

“Any party whose rights, obligations or interests are affected by insolvency proceedings or particular matters in the insolvency proceedings, including the debtor, the insolvency representative, a creditor, an equity holder, a creditor committee, a government authority or any other person so affected. It is not intended that persons with remote or diffuse interests affected by the insolvency proceedings would be considered to be a party in interest.”

**Post-commencement claim**

155. The substance of the drafting was approved.

**Preference**

156. The following proposal for revision of the text was proposed but not fully considered by the Working Group:

“A transaction which results in a creditor obtaining an advantage or irregular payment.”

**Priority**

157. A formulation along the following lines was proposed but for lack of time not fully considered by the Working Group:

“The right of a person to rank ahead of another person where that right arises by operation of law.”

**Priority claim**

158. The Working Group agreed that the term should be retained, with the words “out of available assets” deleted.

**Priority rules**

159. The Working Group supported deletion of the term from the glossary.

**Protection of value**

160. Although some support was expressed in favour of deleting the term, the prevailing view was to retain the first and fourth sentences and to delete the remainder.

**Related person**

161. It was proposed that the text should note the context in which a party might be a related person for the purposes of insolvency law e.g. avoidance and treatment of claims, and that the insolvency law also should take account of definitions of related person in other laws e.g. corporate law.

162. The following amended text was proposed, but not discussed for lack of time:

“As to a debtor that is a legal entity, a related person would include: (i) a person who is or has been in a position of control of the debtor and (ii) a parent, subsidiary, partner or affiliate. As to a debtor that is a natural person, a related person would include persons who are related to the debtor by consanguinity or affinity.”

163. The following amended terms were proposed, but for lack of time, the Working Group was unable to consider them:

**Secured claim**

“A claim assisted by a security interest taken as a guarantee for a debt enforceable in case of the debtor’s default, the amount of which secured claim shall be equal to the value of the security interest. Any amount by which the claim exceeds the value of the encumbered asset shall be an unsecured claim.

**Secured creditor**

“A creditor holding a security interest.”

**Security interest**

“A right or interest in an encumbered asset to guarantee payment of a claim. Whether established voluntarily or by agreement, a security interest generally

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includes, but is not necessarily limited to, mortgages, pledges, charges and liens.”

**Voluntary restructuring negotiations**

“Negotiations that are not regulated by the insolvency law and will generally involve negotiations between the debtor and some or all of its creditors resulting in a consensual modification of the claims of participating creditors.”

164. Some additional definitions were proposed but not discussed for lack of time. It was agreed that they should be retained in square brackets for consideration by the Commission.

**Debtor in possession**

“[A debtor in a reorganization proceeding which retains full control over the business, with the consequence that the court does not appoint an insolvency representative.]”

**Fraudulent transfer**

“[A transaction made by a debtor which is insolvent or which is made insolvent by the transfer, where the transfer is at an undervalue or is made to defeat, hinder or delay creditors.]”

**E. Draft legislative guide on insolvency law, working paper submitted to  
the Working Group on Insolvency Law at its thirtieth session  
(A/CN.9/WG.V/WP.70 (Part I)) [Original: English]**

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## Introduction

### 1. Organization and scope of the Guide

1. The purpose of the *Guide* is to assist in the establishment of an efficient and effective legal framework to address the financial difficulty of debtors. It is intended to be used as a reference by national authorities and legislative bodies when preparing new laws or reviewing the adequacy of existing laws and regulations. The advice provided in the *Guide* aims at achieving a balance between the need to address the debtor’s financial difficulty as quickly and efficiently as possible with the interests of the various parties directly concerned with that financial difficulty, principally creditors and other parties with a stake in the debtor’s business, as well as with public policy concerns. The *Guide* discusses a number of issues central to the design of an effective and efficient insolvency law, which despite numerous differences of policy and legislative treatment, are recognized in many legal systems. It focuses on insolvency proceedings commenced under the insolvency law and conducted in accordance with that law, with an emphasis on reorganization, but also

discusses the increasing use and importance of restructuring negotiations entered into voluntarily between a debtor and its creditors, and not regulated by the insolvency law. In addition to addressing the requirements of domestic insolvency laws, the *Guide* includes the text and Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency.

2. The *Guide* does not provide a single set of model solutions to address the issues central to an effective and efficient insolvency law, but it assists the reader to evaluate different approaches available and to choose the one most suitable in the national or local context. The first section of each chapter of the *Guide* contains a commentary identifying the key issues for consideration and discussing and analysing the various approaches adopted by insolvency laws. The second part of each chapter contains a set of recommended legislative principles. These recommendations are intended to assist in the establishment of a legislative framework for insolvency that is both efficient and effective and reflects modern developments and trends in the area of insolvency. The user is advised to read the legislative recommendations together with the commentary, which provides detailed background information to enhance understanding of the legislative recommendations, as well as a discussion of issues not included as recommendations. In view of the key importance of secured creditors to insolvency proceedings and the policy considerations associated with their treatment under an insolvency law, the user of this *Guide* is also encouraged to consider the UNCITRAL Legislative Guide on Secured Transactions.

3. The recommendations included in the *Guide* deal with core issues that are important to address in legislation specifically concerned with insolvency. They do not deal with other areas of law, which, as discussed throughout the *Guide*, have an impact on both the design of an insolvency law and insolvency proceedings commenced under that law. Moreover, the successful implementation of an insolvency regime requires various measures beyond the establishment of an appropriate legislative framework, especially an adequate institutional infrastructure, organizational capacity, technical professional expertise, and appropriate human and financial resources. Although these matters are discussed in the commentary, they are generally not addressed in the legislative recommendations, except where they relate to the insolvency professional appointed to administer the insolvency estate.

## **2. Glossary**

### **A. Notes on terminology**

4. The following terms are intended to provide orientation to the reader of the Guide. Many terms such as “secured creditor”, “liquidation” and “reorganization” may have fundamentally different meanings in different jurisdictions and the inclusion of a definition in the Guide may assist in ensuring that the concepts as discussed in the Guide are clear and widely understood.

#### **References in the Guide to the “court”**

5. The Guide assumes that there is reliance on court supervision throughout the insolvency proceedings which may include the power to commence insolvency proceedings, to appoint the insolvency representative, to supervise its activities and



to take decisions in the course of the proceedings. Although this reliance may be appropriate as a general principle, alternatives may be considered where, for example, the courts are unable to handle insolvency work (whether for reasons of lack of resources or lack of requisite experience) or supervision by an administrative agency is preferred (see part one, chapter III, Institutional framework). Given the specialized nature of the process and the task performed by a facilitating agency in the context of the administrative processes described in part one, chapter II, it is not intended that such an agency would necessarily be regarded as a court within the usage of that term in the Guide.

6. For the purposes of simplicity the Guide uses the word “court” in the same way as article 2 (e) of the UNCITRAL Model Law on Cross-Border Insolvency to refer to a judicial or other authority competent to control or supervise an insolvency proceeding.

#### **Reference to “the law”**

7. References in the *Guide* to “the law” are to the insolvency law unless otherwise specified.

#### **Rules of interpretation**

8. “Or” is not intended to be exclusive; use of the singular also includes the plural; and “include” and “including” are not intended to indicate an exhaustive list; “may” indicates permission and “should” indicates instruction; “such as” and “for example” are to be interpreted in the same manner as “include” or “including”.

### **B. Terms and definitions**

Administrative claim or expense	Claims which include costs and expenses of the proceedings such as remuneration of the insolvency representative and any professionals employed by the insolvency representative, expenses for the continued operation of the debtor; debts arising from the proper exercise of the insolvency representative’s functions and powers, costs arising from continuing contractual obligations, and costs of proceedings.
Application for commencement of insolvency proceedings	An application for the commencement of insolvency proceedings which may be made, inter alia, by the debtor, creditors or a government authority.
[Assets of the debtor	Property, rights and interests of the debtor including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor’s interests in assets subject to a security interest or in third party-owned assets.]
Avoidance provisions	Provisions which permit transactions occurring prior to insolvency proceedings to be cancelled or otherwise rendered ineffective in the collective interests of

	creditors or the insolvency estate for reasons related to insolvency.
Burdensome assets	Assets that may have no value or an insignificant value to the insolvency estate, for example where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money.
Centre of main interests	The place where the debtor conducts the administration of its interests on a regular basis and that is therefore ascertainable by third parties. <sup>1</sup>
Claim	A right to claim from the debtor money or assets which may be based upon a debt or contract, may be liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, fixed or contingent.
Commencement of proceedings	The event determining the date as of which the effects of insolvency are applicable or the judicial decision to commence insolvency proceedings, whether it is a final decision or not.
Creditor committee	Representative body appointed in accordance with the insolvency law having consultative and other powers as specified in the insolvency law.
Debtor	A natural or legal person engaged in a business, which meets the criteria for commencement of insolvency proceedings.
Discharge	Release of a debtor from liabilities that were, or could have been, addressed in the insolvency proceedings.
Disposal	Every means of transferring or parting with an asset or an interest in an asset, whether in whole or in part.
Encumbered asset	An asset in respect of which a security interest has been obtained by a creditor.
Establishment	Any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services [UNCITRAL Model Law on Cross-Border Insolvency, art. 2 (f)].
Estate	See Insolvency estate.
[Financial contract	Any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial

<sup>1</sup> EC Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings, recital (13).

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	markets and any combination of the transactions mentioned above [UNCITRAL Convention on the Assignment of Receivables in International Trade (2002), art. 5 (k)].
[Government authority	A State or subdivision of a State including a department, agency, instrumentality or other representative thereof.]
Insolvency	When the debtor is generally unable to pay its debts as they mature or when its liabilities exceed the value of its assets.
Insolvency estate	Assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings.
Insolvency proceedings	Collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor's business, conducted according to the insolvency law.
Insolvency representative	A person or body responsible for administering the insolvency estate.
Liquidation	Proceedings to assemble and reduce the debtor's assets to money for distribution in accordance with the insolvency law.
[Netting	In one form it can consist of set-off (see "set-off") of non-monetary fungibles (such as securities or commodities deliverable on the same day, known as settlement netting) and in its more important form it consists of a cancellation by a counterparty of open contracts with the debtor, followed by a set-off of losses and gains either way (close-out netting).]
[Netting agreement	An agreement between two or more parties that provides for one or more of the following: <ul style="list-style-type: none"> <li>(i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;</li> <li>(ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or</li> <li>(iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements. [UNCITRAL Convention on the Assignment of Receivables in International Trade (2002), art. 5 (l)].</li> </ul>
Ordinary course of	Transfers or transactions consistent with operation of the

business	business prior to insolvency proceedings.
<i>Pari passu</i>	The principle according to which similarly situated creditors are treated proportionate to their claim and are satisfied proportionately out of the assets of the estate].
Party in interest	The debtor, the insolvency representative, a creditor, an equity holder, a creditor committee a government authority or any other person whose rights, obligations or interest are affected by insolvency proceedings. <sup>2</sup>
Post-commencement claim	A claim arising from an act or omission occurring after commencement.
Preference	A transaction made by an insolvent debtor where a creditor obtains, or receives the benefit of, more than its pro rata share of the debtor's assets.
[Priority	The right of a person in preference to the right of another person and, to the extent relevant for such purpose, includes the determination of whether the right is a personal or a property right, whether or not it is a security right for indebtedness or other obligation and whether any requirements necessary to render the right effective against a competing claimant have been satisfied [UNCITRAL Convention on the Assignment of Receivables in International Trade, art. 5].]
[Priority claim	A claim that will be paid out of available assets before payment of general unsecured creditors.]
[Priority rules	The rules by which distributions are ordered among creditors and equity interests.]
[Protection of the value of encumbered assets	Measures directed at maintaining the economic value of a security interest during the insolvency proceedings (in some jurisdictions referred to as "adequate protection"). This protection may be particularly relevant where the value of the secured claim is greater than the value of the encumbered asset or even where the value of the encumbered asset exceeds the value of the secured claim, but the value of the encumbered asset is diminishing and ultimately may be insufficient to satisfy the secured claim. Such diminution in value may be affected by the application of the stay to secured creditors or by the use of the encumbered asset in the insolvency proceedings. Protection may be provided by way of cash payments, provision of alternative or additional security or by other means as determined by a court to provide the necessary protection. Where the value of the encumbered asset exceeds that of the

<sup>2</sup> It is not intended that this definition would include persons with a remote or diffuse interest affected by the insolvency law or proceedings.

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	secured claim, and is unlikely to diminish, protection may not be required.]
[Related person	A person who is or has been in a position of control of the debtor including a director or officer of a legal entity, a shareholder or member of such legal entity, a director or officer or shareholder of a legal entity that is related to the debtor, including any relative of such a person; a “relative” in relation to a related person means the spouse, parent, grandparent, son, daughter, brother or sister of the related person.]
[Reorganization	Process by which the financial well-being and viability of a debtor’s business can be restored and the business continue to operate, using various means possibly including debt forgiveness, debt rescheduling, debt-equity conversions and sale of the business (or parts of it) as a going concern.].
[Reorganization plan	A plan by which the financial well-being and viability of the debtor’s business can be restored. The insolvency law may provide for the plan to be submitted by various parties (the debtor, the creditors, the insolvency representative) and may require confirmation of the plan by the court following its approval by the requisite number of creditors. The plan may address issues such as timing of the process, commitments to be undertaken, terms of payment and securities to be offered to creditors, avoidance actions to be filed and treatment of pending contracts including employment contracts.]
[Retention of title	Provision of a contract for the supply of goods which purports to reserve ownership of the goods with the supplier until payment of the purchase price.]
Sale as a going concern	Sale or transfer of a business in whole or substantial part, as opposed to the sale of separate assets of the business.
[Secured claim	A claim assisted by a security interest taken as a guarantee for a debt enforceable in case of the debtor’s default when the debt falls due.]
[Secured creditor	A creditor holding either a security interest covering all or part of the debtor’s assets or a security interest in a specific asset entitling the creditor to priority ahead of other creditors with respect to the secured asset.]
[Secured debt	[Aggregate amount of secured claims] or [claims pertaining to secured creditors].]
[Security interest	A right or interest granted by a party committing the party to pay or perform an obligation. Whether established voluntarily by agreement or involuntarily by

	operation of law, a security interest generally includes, but is not necessarily limited to, mortgages, pledges, charges and liens. “Securities” means any shares, bonds or other financial instruments or assets (other than cash), or any interest therein.]
[Set-off	Where a claim for a sum of money owed to a person is “set-off” (balanced) against a claim by the other party for a sum of money owed by that first person. A set-off may operate as a defence in whole or part to a claim for a sum of money.]
[State-owned enterprise	[ <i>to be completed</i> ]]
[Stay of proceedings	A measure which prevents the commencement, or suspends the continuation, of judicial, administrative or other individual actions concerning the debtor’s assets, rights, obligations or liabilities, including the perfection or enforcement of any security interest; and prevents execution against the assets of the insolvency estate, the termination of a contract with the debtor, and the transfer, encumbrance or other disposition of any assets or rights of the insolvency estate.]
[Superpriority	A priority that will result in claims to which the superpriority attaches being paid before administrative claims.]
[Suspect period	The period of time by reference to which certain transactions may be subject to avoidance. The period is generally calculated retroactively from the date of the application for commencement of insolvency proceedings or from the date of commencement.]
[Unsecured creditor	Any creditor who does not hold security or any ordinary creditor who has no preferential rights.]
[Unsecured debt	Aggregate amount of claims not supported by security.]
Voluntary restructuring negotiations	Negotiations that are not regulated by the insolvency law and will generally involve the debtor and some or all of its creditors.

## Part One

# Designing the key objectives and structure of an effective and efficient insolvency law

### I. Introduction

9. When a debtor is unable to pay its debts and liabilities as they become due, most legal systems provide a legal mechanism to address the collective satisfaction of the outstanding claims from all assets (whether tangible or intangible) of the debtor. A range of interests needs to be accommodated by that legal mechanism: the parties including the debtor, the owners and management of the debtor, the creditors who may be secured to varying degrees (including tax agencies and other government creditors), employees, guarantors of debt and suppliers of goods and services, as well as the legal, commercial and social institutions and practices that are relevant to the design of the insolvency law, including the institutional framework required for its operation. Generally, the mechanism must strike a balance not only between the different interests of these stakeholders but also between those interests and the relevant social, political and other policy considerations that impact upon the economic and legal goals of insolvency.

10. Most legal systems contain rules on various types of proceedings (which are referred to in this *Guide* by the generic term “insolvency proceedings”) that can be initiated to resolve a debtor’s financial difficulties. While addressing that resolution as a common goal, these proceedings take a number of different forms, for which uniform terminology is not always used, and may include both what might be described as “formal” and “informal” elements. Formal insolvency proceedings are those commenced under the insolvency law and governed by that law. They generally include both liquidation and reorganization proceedings. Informal insolvency processes are not regulated by the insolvency law and will generally involve voluntary negotiations between the debtor and some or all of its creditors. Often these types of negotiations have been developed through the banking and commercial sectors and typically, provide for some form of reorganization of the insolvent debtor. While not regulated by an insolvency law, these voluntary negotiations nevertheless depend for their effectiveness upon the existence of an insolvency law which can provide some indirect incentives or persuasive force to achieve a reorganization (discussed further below).

#### A. Key objectives of an effective and efficient insolvency law

11. Although country approaches vary, there is broad agreement that effective and efficient insolvency regimes should aim to achieve the key objectives identified below. Whatever design is chosen for an insolvency law that will meet these key objectives, the insolvency law must be complementary to, and compatible with, the legal and social values of the society in which it is based and which it must ultimately sustain. Although insolvency law generally forms a distinctive regime, it ought not to produce results that are fundamentally in conflict with the premises upon which the general law is based. Where the insolvency law does seek to achieve a result that differs or fundamentally departs from the general law (e.g. with respect

to treatment of contracts, avoidance of antecedent acts and transactions or treatment of the rights of secured creditors) it is highly desirable that that result be the product of careful consideration and conscious policy in that direction.

**1. Provide certainty in the market to promote economic stability and growth**

12. Insolvency laws and institutions are critical to enabling countries to achieve the benefits and avoid the pitfalls of integration of national financial systems with the international financial system. Those laws and institutions should promote restructuring of viable business and efficient closure and transfer of assets of failed businesses, facilitate the provision of finance for start-up and reorganization of businesses, and enable assessment of credit risk, both domestically and internationally. The following key objectives of an insolvency law should be implemented with an overall goal of providing certainty in the market and promoting economic stability and growth.

**2. Maximize value of assets**

13. Participants in insolvency proceedings should have strong incentives to achieve maximum value for assets, as this will facilitate higher distributions to creditors as a whole and reduce the burden of insolvency. The achievement of this goal is often furthered by achieving a balance between the risks allocated between the parties involved in insolvency proceedings. The manner in which prior transactions are treated, for example, can ensure that creditors are treated equitably and enhance the value of the debtor's assets by recovering value for the benefit of all creditors. At the same time, the treatment afforded those transactions can undermine the predictability of contractual relations that is critical to investment decisions, creating a tension between the different objectives of an insolvency regime. Similarly, a balance has to be struck between rapid liquidation and longer-term efforts to reorganize the business which may generate more value for creditors, between the need for new investment to preserve or improve the value of assets and the implications and cost of that new investment on existing stakeholders, and between the different roles allocated to the different stakeholders, in particular the discretion that can be exercised by the insolvency representative and the extent to which creditors can monitor the exercise of that discretion to safeguard the process.

**3. Strike a balance between liquidation and reorganization**

14. The first objective of maximization of value is closely linked to the balance to be achieved in the insolvency law between liquidation and reorganization. An insolvency law needs to balance the advantages of near-term debt collection through liquidation (often the preference of secured creditors) against maintaining the debtor as a viable business through reorganization (often the preference of unsecured creditors). Achieving that balance may implicate other social policy considerations such as encouraging the development of an entrepreneurial class and protecting employment. Insolvency law should include the possibility of reorganization of the debtor as an alternative to liquidation, where creditors would not involuntarily receive less than in liquidation and the value of the debtor to society and to creditors may be maximized by allowing it to continue. This is predicated on the basic economic theory that greater value may be obtained from keeping the essential components of a business together, rather than breaking them up and disposing of



them in fragments. To ensure that insolvency proceedings are not abused by either creditors or the debtor, and that the procedure most appropriate to resolution of the debtor's financial difficulty is available, an insolvency law should also provide for conversion between the different types of proceedings in appropriate circumstances.

#### **4. Ensure equitable treatment of similarly situated creditors**

15. The objective of equitable treatment is based on the notion that in collective proceedings, creditors with similar legal rights should be treated equally, receiving a distribution on their claim in accordance with their relative priority and interests. Equitable treatment recognizes that all creditors do not need to be treated equally, but in a manner that reflects the different bargains they have struck with the debtor, although this becomes less relevant as a defining factor where there is no specific debt contract with the debtor, such as in the case of damage claimants (e.g. for environmental damage). To the extent that equitable treatment is modified by social policy on claim priorities and should give way to the prerogatives pertaining to holders of claims or interests that arise, for example, by operation of law, the principle of equitable treatment retains its significance by ensuring that the priority accorded to the claims of a similar class affects all members of the class in the same manner. The policy of equitable treatment permeates many aspects of an insolvency law, including the application of the stay or suspension, provisions to set aside acts and transactions and recapture value for the insolvency estate, classification of claims, voting procedures in reorganization, and distribution mechanisms. An insolvency law should address problems of fraud and favouritism that may arise in cases of financial distress by providing, for example, that acts and transactions detrimental to equitable treatment of creditors can be avoided.

#### **5. Provide for timely, efficient and impartial resolution of insolvency**

16. Insolvency should be addressed and resolved in an orderly, quick and efficient manner, with a view to avoiding undue disruption to the business and the activities of the debtor and to minimizing the cost of the proceedings. Achieving timely and efficient administration will support the objective of maximizing asset value, while impartiality supports the goal of equitable treatment. The entire process needs to be carefully considered to ensure maximum efficiency without sacrificing flexibility. At the same time, it should be focused on the goal of liquidating non-viable and inefficient businesses and the survival of efficient, potentially viable businesses.

17. Quick and orderly resolution of a debtor's financial difficulties can be facilitated by an insolvency law that provides easy access to insolvency proceedings by reference to clear and objective criteria, provides a convenient means of identifying, collecting, preserving and recovering assets and rights that should be applied towards payment of the debts and liabilities of the debtor, facilitates participation of the debtor and its creditors with the least possible delay and expense, provides an appropriate structure for supervision and administration of proceedings (including both professionals and the institutions involved) and provides, as an end result, effective relief to the financial obligations and liabilities of the debtor.

**6. Preserve the insolvency estate to allow equitable distribution to creditors**

18. An insolvency law should preserve the estate and prevent premature dismemberment of the debtor's assets by individual creditor actions to collect individual debts. Such activity often reduces the total value of the pool of assets available to settle all claims against the debtor and may preclude reorganization or the sale of the business as a going concern. A stay of creditor action provides a breathing space for debtors, enabling a proper examination of its financial situation and facilitating both maximization of the value of the estate and equitable treatment of creditors. Some mechanism may be required to ensure that the rights of secured creditors are not impaired by a stay.

**7. Ensure a transparent and predictable insolvency law that contains incentives for gathering and dispensing information**

19. An insolvency law should be transparent and predictable. This will enable potential lenders and creditors to understand how insolvency proceedings operates and to assess the risk associated with their position as a creditor in the event of insolvency. This will promote stability in commercial relations and foster lending and investment at lower risk premiums. Transparency and predictability will also enable creditors to clarify priorities, prevent disputes by providing a backdrop against which relative rights and risks can be assessed, and help define the limits of any discretion. Unpredictable application of the insolvency law has the potential to undermine not only the confidence of all participants in insolvency proceedings, but also their willingness to make credit and other investment decisions. As far as possible, an insolvency law should clearly indicate all provisions of other laws that may affect the conduct of the insolvency proceedings (e.g. labour law; commercial and contract law; tax law; laws affecting foreign exchange, netting and set-off, debt for equity swaps; and even family and matrimonial law).

20. An insolvency law should ensure that adequate information is available in respect of the debtor's situation, providing incentives to encourage the debtor to reveal its positions or, where appropriate, sanctions for failure to do so. The availability of this information will enable those responsible for administering and supervising insolvency proceedings (courts or administrative agencies, the insolvency representative) and creditors to assess the financial situation of the debtor and determine the most appropriate solution.

**8. Recognize existing creditor rights and establish clear rules for ranking of priority claims**

21. Recognition and enforcement in insolvency proceedings of the differing rights that creditors have outside of insolvency will create certainty in the market and facilitate the provision of credit, particularly with respect to the rights and priorities of secured creditors. Clear rules for the ranking of priorities of both existing and post-commencement creditor claims are important to provide predictability to lenders, and to ensure consistent application of the rules, confidence in the process and that all participants are able to adopt appropriate measures to manage risk. To the greatest extent possible, those priorities should be based upon commercial bargains and not reflect social and political concerns that have the potential to distort the outcome of insolvency. According priority to claims that are not based on commercial bargains should be avoided.

## 9. Establish a framework for cross-border insolvency

22. To promote coordination among jurisdictions and facilitate the provision of assistance in the administration of an insolvency proceeding originating in a foreign country, insolvency laws should provide rules on cross-border insolvency, including the recognition of foreign proceedings, by adopting the UNCITRAL Model Law on Cross-Border Insolvency.<sup>3</sup>

## B. Balancing the key objectives

23. Since an insolvency regime cannot fully protect the interests of all parties, some of the key policy choices to be made when designing an insolvency law relate to defining the broad goals of the insolvency law (rescuing businesses in financial difficulty, protecting employment, protecting the interests of creditors, encouraging the development of an entrepreneurial class) and achieving the desired balance between the specific objectives identified above. Insolvency laws achieve that balance by reapportioning the risks of insolvency in a way that suits a country's economic, social and political goals. As such an insolvency law can have widespread effects in the broader economy.

24. The first task for an insolvency law is to establish a framework of principles that determines how the estate of the insolvent debtor is to be administered for the benefit of all affected parties. The creation of such a framework and its integration with the wider legal process are vital to maintaining social order and stability. All parties need to be able to anticipate how their legal rights will be affected in the event of a debtor's inability to pay, or to pay in full, what is owed to them. This allows both creditors and equity investors to calculate the economic implications of default by the debtor, and so estimate their risks. These issues are discussed in detail throughout the *Guide*.

25. There is no universal solution to the design of an insolvency law because countries vary significantly in their needs, as do their laws on other issues of key importance to insolvency, such as security interests,<sup>4</sup> property and contract rights, remedies and enforcement procedures. Although there may be no universal solution, most insolvency laws address the range of issues raised by the key objectives, albeit with different emphasis and focus. Some laws favour stronger recognition and enforcement of creditor rights and commercial bargains in insolvency and give creditors more control over the conduct of insolvency proceedings than the debtor (sometimes referred to as "creditor-friendly" regimes). Other laws lean towards giving the debtor more control over the proceedings (referred to as "debtor-friendly" regimes), while yet others seek to strike a balance in the middle. Some laws give more prominence to liquidation of the debtor in order to weed out inefficient and incompetent market players, while others favour reorganization. The focus on reorganization may serve a number of different aims: as a means of enhancing the value of creditors' claims as part of an ongoing business concern, providing a

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<sup>3</sup> See chapter VII.

<sup>4</sup> Steps have been taken in recent years towards harmonizing the law on security interests, such as the United Nations Convention on the Assignment of Receivables in International Trade (2001), the Unidroit Convention on International Interests in Mobile Equipment and current work by UNCITRAL to develop a legislative guide on secured transactions.

second chance to the shareholders and management of the debtor; providing strong incentives for the adoption by entrepreneurs and managers of appropriate attitudes to risk; or protecting vulnerable groups, such as the debtor's employees, from the effects of business failure.<sup>5</sup> Some laws give particular emphasis to the protection of employees and the maintenance of employment in insolvency, while others provide that business can be downsized with minimum protections afforded to employees.

26. But adopting a reorganization-friendly approach should not result in establishing a safe haven for moribund enterprises—enterprises that are beyond rescue should be liquidated as quickly and efficiently as possible. To the extent that some interests may be regarded as being of lower priority than others, the establishment of mechanisms outside of the insolvency law may provide a better solution than trying to address those interests under the insolvency regime. For example, where as a matter of policy it is decided that employee claims should rank lower than secured and priority creditors in insolvency, insurance arrangements can be used to protect employee entitlements.

27. Because society is constantly evolving, insolvency law cannot be static, but requires reappraisal at regular intervals to ensure that it meets current social needs. Responses to perceived social change involve an act of judgement that can be informed by international best practice and those practices transposed into national insolvency regimes, taking into account the realities of the system and available human and material resources.

### C. General features of an insolvency law

28. Designing an effective and efficient insolvency law involves the consideration of a common set of issues relating to both the legal framework (rights and obligations of the parties, both substantively and procedurally) and the institutional framework (to implement these rights and obligations) required. The substantive issues, which are discussed in detail in part two of the *Guide*, include:

(a) Identifying the debtors that may be subject to insolvency proceedings, including those debtors that may require a special insolvency regime;

(b) Determining when insolvency proceedings may be commenced and the type of proceeding that may be commenced, the party that may request commencement and whether the commencement criteria should differ depending upon the party requesting commencement;

(c) The extent to which the debtor should be allowed to retain control of the business once insolvency proceedings commence or be displaced and an independent party (in the *Guide* referred to as the insolvency representative)

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<sup>5</sup> There is not necessarily a direct correlation between the debtor or creditor friendliness of an insolvency regime, the emphasis on liquidation or reorganization and the subsequent success or failure of reorganization. While it is beyond the scope of this *Guide* to discuss these issues in any detail, they are important for the design of an insolvency regime and deserve consideration. While the rate of successful reorganizations varies considerably among those regimes classified as creditor-friendly, research appears to suggest that the assumption that creditor-friendly regimes lead to fewer or less successful reorganizations than debtor-friendly regimes is not necessarily true.

appointed to supervise and manage the debtor, and the distinction to be made between liquidation and reorganization in that regard;

(d) Protection of the assets of the debtor against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

(e) The manner in which the insolvency representative may deal with contracts entered into by the debtor before the commencement of proceedings and in respect of which both the debtor and its counterparty have not fully performed their respective obligations;

(f) The extent to which setoff or netting rights can be enforced or will be protected, notwithstanding the commencement of the insolvency proceedings;

(g) The manner in which the insolvency representative may use or dispose of assets of the insolvency estate;

(h) The extent to which the insolvency representative can avoid certain types of transactions that result in the interests of creditors being prejudiced;

(i) In the case of reorganization, preparation of the reorganization plan and the limitations, if any, that will be imposed on the content of the plan, the preparer of the plan and the conditions required for its approval and implementation;

(j) The ranking of creditors for the purposes of distributing the proceeds of liquidation;

(k) Implementation of the reorganization plan;

(l) Distribution of the proceeds of liquidation;

(m) Discharge or dissolution of the debtor in liquidation; and

(n) Conclusion of the proceedings.

29. In addition to these specific subject areas, a more general issue to be considered is how an insolvency law will relate to other substantive laws and whether the insolvency law will effectively modify those laws. Relevant laws may include labour laws that provide certain protections to employees, laws that limit the availability of set-off and netting, laws that limit debt-for-equity conversions and laws that impose foreign exchange and foreign investment controls that may affect the content of a reorganization plan (see labour contracts and employees, part two, chapters II.E and V.B; setoff and netting, part two, chapters G and H; and content of reorganization plan, part two, chapter IV).

30. While the institutional framework is not discussed in any detail in this *Guide*, some of the issues are touched upon below. Notwithstanding the variety of substantive issues that must be resolved, insolvency laws are highly procedural in nature. The design of the procedural rules plays a critical role in determining how roles are to be allocated among the various participants, particularly in terms of decision-making. To the extent that the insolvency law places considerable responsibility upon the institutional infrastructure to make key decisions, it is essential that that infrastructure be sufficiently developed to perform the required functions.

## II. Mechanisms for resolving a debtor's financial difficulties

### A. Voluntary restructuring negotiations

31. Voluntary restructuring negotiations were developed some years ago by the banking sector, as an alternative to formal reorganization proceedings under the insolvency law. Led and influenced by internationally active banks and financiers, this type of negotiation has gradually spread to a considerable number of jurisdictions, although use of them varies—in some jurisdictions they are reported to be rarely used, whilst in others most reorganizations are reported to be conducted by way of such negotiations. To some extent these results may reflect the existence (or not) of what is sometimes described as a “rescue culture”—the degree to which participants regard this type of negotiation as likely to be successful, irrespective of the formal absence of features of proceedings under the insolvency law, such as a stay.

32. The use of voluntary restructuring negotiations has generally been limited to cases of corporate financial difficulty or insolvency in which there is a significant amount of debt owed to banks and financiers. The negotiations are aimed at securing contractual arrangements both between the lenders themselves and the lenders and the debtor for the restructuring of the debtor, with or without rearrangement of the financing. This can provide a means of introducing flexibility into an insolvency regime by reducing the burden on judicial infrastructure, facilitating an earlier pro-active response from creditors than would normally be possible under formal insolvency proceedings and avoiding the stigma that often attaches to insolvency. While not based or reliant upon the provisions of the insolvency law, use of this type of negotiation depends very largely for its success upon the existence and availability of an effective and efficient insolvency law and supporting institutional framework<sup>6</sup> to provide sanctions that can assist to make the voluntary negotiations successful. Unless the debtor and its bank and financial creditors take the opportunity to join together and voluntarily enter into these negotiations, the debtor or the creditors can invoke the insolvency law, with some potential for detriment to both the debtor and its creditors in terms of delay, cost and outcome.

33. Although not regulated by the insolvency law, many legal systems do contemplate that a debtor can enter into agreements or arrangements with some of all of its creditors which may be governed by, for example, contract law, company or commercial law or civil procedural law, or in some cases relevant banking regulations. However, there are a few jurisdictions which do not allow agreements or arrangements designed to restructure the debtor and its debt to occur outside of the court system or the insolvency law. Some laws would regard the steps associated with such voluntary restructuring negotiations as sufficient for the courts to make a declaration of insolvency. Similarly, there are a number of jurisdictions which, because they impose on the debtor an obligation to commence formal insolvency proceedings within a certain time after a defined event of insolvency, restrict the conduct of such voluntary negotiations to circumstances where the formal conditions for commencement of proceedings have not been met. Nevertheless, it is

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<sup>6</sup> See the discussion of institutional framework in chapter III below.

suggested that banks and other creditors in these jurisdictions do often use various techniques to achieve some form of reorganization of debtors.

### **1. Necessary preconditions**

34. Voluntary restructuring negotiations depend for their effectiveness on a number of well-defined initial premises. These may include:

(a) A significant amount of debt owed to a number of main banks or financial institution creditors;

(b) The present inability of the debtor to service that debt;

(c) Acceptance of the view that it may be preferable to negotiate an arrangement, as between the debtor and the financiers and also between the financiers themselves, to resolve the financial difficulties of the debtor;

(d) The use of relatively sophisticated refinancing, security and other commercial techniques that might be employed to alter, rearrange or restructure the debts of the debtor or the debtor itself;

(e) The sanction that if the negotiation process cannot be started or breaks down there can be swift and effective resort to the insolvency law;

(f) The prospect that there may be a greater benefit for all parties through the negotiation process than by direct and immediate resort to the insolvency law (in part because the outcome is subject to the control of the negotiating parties and the process is less expensive and can be accomplished quickly without disrupting the debtor's business);

(g) The debtor does not need relief from trade debts, or the benefits of formal insolvency, such as the automatic stay or the ability to reject burdensome debts; and

(h) Favourable or neutral tax treatment for reorganization both in the debtor's jurisdiction and the jurisdictions of foreign creditors.

### **2. Main processes**

35. To be effective, voluntary restructuring negotiations require a number of different steps to be followed and range of skills to be employed. The main elements in the process are discussed below.

#### **(a) Commencing the negotiations**

36. Voluntary negotiations essentially involve bringing together the debtor and creditors or at least the main creditors, one or more of whom must initiate the negotiations (as there can be no reliance upon a law or a facilitator for initiation, imposition or assistance of the negotiations). A debtor might be unwilling to commence a dialogue with creditors or at least with all of its creditors and creditors, while concerned for their own position, may have little interest in collective negotiations. It is at this point that the availability and effectiveness of individual creditor remedies or formal insolvency proceedings can be used to encourage the commencement and progress of the such negotiations. A debtor who remains reluctant to participate may find itself subject to individual debt or security

enforcement actions or even insolvency proceedings, which it will not be able to defeat or delay. At the same time, creditors may also find themselves subject to formal insolvency proceedings which effectively prevent them from enforcing their individual rights and might not represent the optimal process for recovery of their debt. Creating a forum in which the debtor and creditors can come together to explore and negotiate an arrangement to deal with the debtor's financial difficulty therefore is crucial.

**(b) Coordinating participants—appointing a lead creditor and steering committee**

37. The voluntary negotiations would need to involve all key constituencies; generally the lenders group and sometimes key creditor constituencies who may be affected by a voluntary restructuring agreement are critical to the negotiations. To better coordinate negotiations, a principal creditor is often appointed to provide leadership, organization, management and administration. This creditor typically reports to a committee that is representative of all creditors (a steering committee) and can provide assistance and act as a sounding board for proposals regarding the debtor.

**(c) Agreeing a “standstill”**

38. To allow business operations to continue and to ensure that sufficient time is available to obtain and evaluate information about the debtor and to formulate and assess proposals to resolve the debtor's financial difficulties, a contractual agreement to suspend adverse actions by both the debtor and the main creditors may be required. That agreement would generally need to endure for a defined, usually short period, unless inappropriate in a particular case.

**(d) Engaging advisors**

39. Few, if any, attempts are made at voluntary restructuring without the involvement of independent experts and advisors from various disciplines (e.g. legal, accounting, finance and business regulation, marketing). While it may be suggested that this involvement will lead to unnecessary cost and intrusion into the affairs of the debtor and creditors, as well as a loss of control, it is generally necessary to ensure the provision of information, independently verified, as well as professionally developed plans for refinancing, restructuring, management and operation that are essential to the success of these negotiations.

**(e) Ensuring adequate cash flow and liquidity**

40. A debtor that becomes a candidate for voluntary restructuring negotiations will often require continued access to established lines of credit or the provision of fresh credit. Provision of credit by existing secured creditors may not present a problem. Where this is not available, however, and fresh credit is required, there may be difficulties in guaranteeing the eventual repayment of the fresh credit if the negotiations fail. While this issue can be addressed under the insolvency law by providing some form of priority for such ongoing lending (see part two, chapter II.D), the law will not generally extend to an agreement reached by way of voluntary negotiations.



41. Those creditors who participate in voluntary negotiations, nevertheless, can agree amongst themselves that if one or more of them extends further credit the others will subordinate their claims to enable the new credit to be repaid ahead of their own claims. Thus, as between those creditors, there will be a contractual agreement for the repayment of new money where the restructuring negotiations are successful. Where the negotiations fail, however, and the debtor is liquidated, the creditor who has provided the fresh credit may be left with an unsecured claim (unless security was provided) and receive only partial repayment along with other unsecured creditors.

**(f) Access to information on the debtor**

42. Access to complete, accurate information on the debtor is essential to enable proper evaluation to be made of the financial position of the debtor and any proposals to be made to relevant creditors. Information concerning the assets, liabilities and business of the debtor will need to be made available to all relevant creditors but unless already publicly available, may need to be treated as confidential.

**(g) Dealing with creditors**

43. The complexity of the interests of creditors often presents critical problems for voluntary negotiations. Providing for these differing interests, and persuading those creditors that have already commenced recovery or enforcement action against the debtor that they should participate in the negotiations may be possible only if there is a prospect of a better result through those negotiations or if the threat of formal insolvency proceedings will restrain creditors from pursuing their individual rights.

44. In many cases, however, it will not be possible (or indeed necessary) to involve every creditor in the negotiations, either because of their number and diverse interests or because of the inefficiency of involving creditors who are owed only small amounts of money or who do not have the commercial expertise, knowledge or will to participate effectively. While creditors who fall into these categories often may be left out of the negotiations, they cannot be ignored as they may be important to the continued operation of the business (as suppliers of essential goods or services or as participants in essential parts of the debtor's production process) and there are no rules which can compel such creditors to accept the decision of a majority of their number.

45. Often in a voluntary restructuring agreement, trade and small creditors recover payment in full. Although this suggests unequal treatment, it may make commercial sense to a group of major creditors. An alternative approach is to secure agreement of the main creditors to a restructuring plan and then use the plan as the basis of a formal court supervised reorganization process in which other creditors participate (sometimes referred to as a "pre-packaged" plan and in this *Guide* as expedited reorganization proceedings—see part two, chapter IV.B). This plan can then bind the other creditors. Without an effective formal insolvency regime, this result could not be achieved in those circumstances.

### 3. Rules and guidelines for voluntary restructuring

46. To assist the conduct of voluntary restructuring negotiations, and in particular to address the problems noted above in the context of complex, multinational businesses, a number of organizations have developed non-binding principles and guidelines. One such approach is called the “London Approach” named after the non-binding guidelines issued to commercial banks by the Bank of England. Banks are urged to take a supportive attitude toward their debtors that are in financial difficulties. Decisions about the debtor’s longer-term future should only be made on the basis of comprehensive information, which is shared among all the banks and other parties that would be involved in any agreement as to the future of the debtor. Interim financing is facilitated by a standstill and subordination agreement, and banks work together with other creditors to reach a collective view on whether and on what terms a debtor entity should be given a financial lifeline. Similar guidelines have been developed by the central banks of other countries. An international organization which has undertaken work in this area is the International Federation of Insolvency Professionals (INSOL), which has developed *Principles for a global approach to multi-creditor workouts*. The *Principles* are designed to expedite voluntary restructuring negotiations and increase the prospects of success by providing guidance to diverse creditor groups about how to proceed on the basis of some common agreed rules.

### B. Insolvency proceedings

47. Two main types of proceedings are common to the majority of insolvency laws: reorganization and liquidation.

48. The traditional division or distinction between these two types of proceedings can be somewhat artificial and can create unnecessary polarization and inflexibility. It does not accommodate, for example, cases not easily situated at the poles—those cases where a flexible approach to the debtor’s financial situation is likely to achieve the best result for both the debtor and the creditors in terms of maximizing the value of the insolvency estate. For example, the term “reorganization” is sometimes used to refer to a particular way of ensuring preservation and possible enhancement of the value of the insolvency estate in the context of liquidation proceedings, such as where the law provides for liquidation to be carried out by transferring the business to another entity as a going concern. In that situation, the term “reorganization” merely points to a technique other than traditional liquidation (i.e. straightforward, piecemeal sale or realization of the assets), being used in order to obtain as much value as possible from the insolvency estate. To achieve such a sale or realization, the insolvency law may need to include an element of flexibility not generally available in laws which define liquidation as a sale of assets as soon as possible and allow the business to be continued only for that purpose. Some laws, for example, actually provide the power for the insolvency representative to effect a more advantageous sale or realization of the debtor’s assets than would be effected in liquidation. Similarly, reorganization may require the sale of significant parts of the debtor’s business or contemplate an eventual liquidation or sale of the business to a new company and the dissolution of the existing debtor.

49. For these reasons, it is desirable that an insolvency law provides more than a choice between a single, narrowly defined type of reorganization and strictly traditional liquidation. Since the concept of reorganization can accommodate a variety of arrangements, it is desirable that an insolvency law adopt an approach that is not prescriptive and supports arrangements that will achieve a result that provides more value to creditors than if the debtor was liquidated.

50. In discussing the core provisions of an effective and efficient insolvency regime, this *Guide* focuses upon reorganization proceedings on the one hand and liquidation proceedings on the other. However, the adoption of this approach is not intended to indicate a preference for particular types of proceedings or a preference for the manner in which the different proceedings should be integrated into an insolvency law. Rather, the *Guide* seeks to compare and contrast the core elements of the different types of proceedings and to promote an approach that focuses upon maximizing the result for the parties involved in an insolvency rather than upon strictly defined types of proceedings. This may be achieved by designing an insolvency law that incorporates the traditional formal elements in a way that promotes maximum flexibility.

### **1. Reorganization proceedings**

51. A means of resolving a debtor's financial difficulties is a reorganization which is designed to save a company or, failing that, a business. This process may take one of several forms and may be more varied as to its concept, acceptance and application than liquidation. For the sake of simplicity, the term "reorganization" is used in the *Guide* in a broad sense to refer to the type of proceedings whose ultimate purpose is to allow the debtor to overcome its financial difficulties and resume or continue normal commercial operations (even though in some cases it may include a reduction in the scope of the business, its sale as a going concern to another company or its eventual liquidation).

52. Not all debtors that falter or experience serious financial difficulty in a competitive marketplace should necessarily be liquidated; a debtor with a reasonable prospect of survival (such as one which has a potentially profitable business) should be given that opportunity where it can be demonstrated that there is greater value (and, by deduction, greater benefit for creditors in the long term) in keeping the essential business and other component parts of the debtor together. Reorganization proceedings are designed to give a debtor some breathing space to recover from its temporary liquidity difficulties or more permanent overindebtedness and, where necessary, provide it with an opportunity to restructure its operations and its relations with creditors. Where reorganization is possible, generally it will be preferred by creditors if the value derived from the continued operation of the debtor's business will enhance the value of their claims. Reorganization, however, does not imply that all of the stakeholders must be wholly protected or that they should be restored to the financial or commercial position that would have obtained had the event of insolvency not occurred. It does not imply that the debtor will be completely restored or its creditors paid in full or that ownership and management of an insolvent debtor will maintain and preserve their respective positions. Management may be terminated and changed, the equity of shareholders may be reduced to nothing, employees may be retrenched and the source of a market for suppliers may disappear. In general, however, reorganization

does imply that whatever form of plan, scheme or arrangement is agreed, the creditors will eventually receive more than if the debtor was to be liquidated.

53. Additional factors supporting the use of reorganization include that the modern economy has significantly reduced the degree to which the value of the debtor's assets can be maximized through liquidation. In cases where technical know-how and goodwill are more important than physical assets, the preservation of human resources and business relations are essential elements of value that cannot be realized through liquidation. Also, long-term economic benefit is more likely to be achieved through reorganization proceedings, since they encourage debtors to take action before their financial difficulties become severe. Lastly, there are social and political considerations that are served by the availability of reorganization proceedings which protect, for example, the employees of a troubled debtor.

54. Reorganization may take a number of different forms. It may include a simple agreement concerning debts (referred to as a composition) where, for example, the creditors agree to receive a certain percentage of the debts owed to them in full, complete and final satisfaction of their claims against the debtor. The debts are thus reduced and the debtor becomes solvent and can continue to trade. They may also include a complex reorganization under which, for example, debts are restructured (e.g. by extending the length of the loan and the period in which payment may be made, deferring payment of interest or changing the identity of the lenders); some debt may be converted to equity together with a reduction (or even extinguishment) of existing equity; the non-core assets may be sold; and the unprofitable business activities closed. The choice of the way in which reorganization is carried out is typically a response to the size of the business and the degree of complexity of the debtor's specific situation.

55. Although reorganization may not be as widely included in insolvency laws as liquidation, and may not, therefore, follow such a common pattern, there are a number of key or essential elements that can be determined:

(a) Submission of the debtor to the proceedings (whether on its own application or on the basis of an application by creditors), which may or may not involve judicial control or supervision;

(b) Automatic and mandatory stay or suspension of actions and proceedings against the assets of the debtor affecting all creditors for a limited period of time;

(c) Continuation of the business of the debtor, either by existing management, an independent manager or a combination of both;

(d) Formulation of a plan which proposes the manner in which creditors, equity holders and the debtor itself will be treated;

(e) Consideration of, and voting on, acceptance of the plan by creditors;

(f) Possibly, the judicial approval/confirmation of an accepted plan; and

(g) Implementation of the plan.

56. The benefits of reorganization are increasingly accepted, and many insolvency laws include provisions on formal reorganization proceedings. The extent to which formal reorganization proceedings, as opposed to some form of voluntary negotiations, are relied upon to achieve the objectives of reorganization varies

between countries. In any event, it is generally recognized that the existence of liquidation under the insolvency law can facilitate the reorganization of a debtor by providing an incentive to both creditors and debtors to reach an appropriate agreement through a reorganization plan.

57. There is often, however, a correlation between the degree of financial difficulty being experienced by the debtor, the complexity of its business arrangements, and the difficulty of the appropriate solution. Where, for example, a single bank is involved, it is likely that the debtor can negotiate a voluntary restructuring agreement with that bank and resolve its difficulties without involving trade creditors and without the need to commence proceedings under the insolvency law. Where the financial situation is more complex and requires the involvement of a large number of different types of creditors, a greater degree of formality may be needed to find a solution that addresses the disparate interests and objectives of these creditors, since voluntary restructuring agreements require unanimity of the parties participating. Reorganization proceedings may assist in achieving the desired goal where those proceedings enable the debtor and a majority of creditors to impose a plan upon a dissenting minority of creditors, especially where there are creditors who “hold out” during out-of-court negotiations. In some cases, proceedings under the insolvency law work well precisely because they are regulated by that law, while in other cases voluntary negotiations succeed because of the lack of regulation.

## **2. Expedited reorganization proceedings**

58. Some countries have adopted what can be described as “pre-insolvency” or “pre-packaged” procedures (in the *Guide*, referred to as “expedited reorganization proceedings”) that are, in effect, a combination of voluntary restructuring negotiations and reorganization proceedings under the insolvency law. One insolvency law, for example, permits proceedings to be commenced to obtain formal court approval of a reorganization plan that was negotiated voluntarily and approved by creditors through a vote that occurred before the commencement of the proceedings. Such proceedings are designed to minimize the cost and delay associated with formal reorganization proceedings while at the same time providing a means by which a reorganization plan negotiated voluntarily nevertheless can be approved in the absence of unanimous support of the creditors. Such a process allows the approval of the restructuring plan obtained in the voluntary negotiations to be used to achieve a reorganization that will bind all creditors, at the same time providing the protections of the insolvency law to affected creditors.

59. Another insolvency law provides that, in order to facilitate the conclusion of an amicable settlement with its creditors, a debtor may ask the court to appoint a “conciliator”. The conciliator has no particular powers but may request the court to impose a stay of execution against all creditors if, in his or her judgement, a stay would facilitate the conclusion of a settlement agreement. During the stay, the debtor may not make any payments to discharge existing debts (except salaries) or dispose of any assets other than in the regular course of business. The procedure ends when agreement is reached either with all creditors or (subject to court

approval) with the main creditors; in the latter case, the court may continue the stay against non-participating creditors by providing a grace period to the debtor of up to two years.

60. These types of procedures are discussed in more detail in part two, chapter IV.B.

### 3. Liquidation

61. The type of proceedings referred to as “liquidation” are regulated by the insolvency law and generally provide for a public authority (typically, although not necessarily, a judicial court acting through a person appointed for the purpose) to take charge of the debtor’s assets, with a view to terminating the commercial activity of the debtor, transforming non-monetary assets into monetary form and subsequently distributing the proceeds of sale or realization of the assets proportionately to creditors. Although generally requiring the sale or realization of assets to occur in a piecemeal manner as quickly as possible, some insolvency laws permit liquidation to involve sale of the business in productive units or as a going concern; under other laws that is only permissible in reorganization. Liquidation usually results in the dissolution or disappearance of the debtor as a commercial legal entity.

62. Liquidation proceedings tend to be very similar in their concept, acceptance and application and normally follow a pattern that includes:

(a) An application to a court or other competent body either by the debtor or by creditors;

(b) An order or judgement that the debtor be liquidated;

(c) Appointment of an independent person to conduct and administer the liquidation;

(d) Closure of the business activities of the debtor, if the business of a debtor cannot be sold as a going concern, and termination of the powers of owners and management and the employment of employees;

(e) Sale or realization of the debtor’s assets, either piecemeal or as a going concern;

(f) Adjudication of the claims of creditors;

(g) Distribution of available funds to creditors (under some form of priority);  
and

(h) Dissolution of the debtor, where it is a corporation or some other form of legal person, or discharge, in the case of a natural person.

63. There are a number of legal and economic justifications for liquidation. Broadly speaking, it can be argued that a commercial business that is unable to compete in a market economy should be removed from the marketplace. A principal identifying mark of an uncompetitive business is one that satisfies one of the tests of insolvency, that is, it is unable to meet its mature debts as they become due or its debts exceed its assets. More specifically, the need for liquidation proceedings can

be viewed as addressing inter-creditor problems (when an insolvent debtor's assets are insufficient to meet the claims of all creditors it will be in a creditor's own best interests to take action to recover its claim before other creditors can take similar action) and as a disciplinary force that is an essential element of a sustainable debtor-creditor relationship. Orderly and effective liquidation proceedings address the inter-creditor problem by setting in motion a collective proceeding that seeks to avoid those actions which, while viewed by individual creditors as being in their own best self interest, essentially lead to the loss of value for all creditors. A collective proceeding is designed to provide equitable treatment to creditors, by treating similarly situated creditors in the same way, and to maximize the value of the debtor's assets for the benefit of all creditors. This is normally achieved by the imposition of a stay on the ability of creditors to enforce their individual rights against the debtor and the appointment of an independent person whose primary duty is to maximize the value of the debtor's assets for distribution to creditors.

64. An orderly and relatively predictable mechanism for the enforcement of the collective rights of creditors can also provide creditors with an element of predictability at the time they make their lending decisions, and as well, can more generally promote the interest of all participants in the economy by facilitating the provision of credit and the development of financial markets. This is not to say that an insolvency law should function as a means of enforcing the rights of individual creditors, although there is a clear and important relationship between enforcement and insolvency mechanisms. The efficiency and effectiveness of procedures for the individual enforcement of creditors' rights will mean that creditors are not forced to use insolvency proceedings for that purpose, especially since insolvency proceedings generally require a level of proof, cost and procedural complexity that makes it unsuitable for use in that way. Nevertheless, effective insolvency proceedings will ensure that where debt enforcement mechanisms fail, creditors will have an avenue of final recourse that can operate as an effective incentive to a recalcitrant debtor to encourage payment to the particular creditor.

#### **4. Organization of the insolvency law**

65. Approaches differ widely as to the structure of the procedure that leads to the choice of one of these processes. Some insolvency laws provide for unitary, flexible insolvency proceedings with a single commencement requirement alternatively resulting in liquidation or reorganization, depending on the circumstances of the case. Other laws provide for two distinct proceedings, each setting forth its own access and commencement requirements, with different possibilities for conversion between the two proceedings. Those laws that treat liquidation and reorganization proceedings as distinct from one another do so on the basis of different social and commercial policy considerations. However, a significant number of issues are common to both liquidation and reorganization, resulting in considerable overlaps and linkages between them, in terms of both procedural steps and substantive issues, as will become evident from the discussion in Part Two, which follows.

66. The determination of whether the business of the insolvent debtor is viable should determine, at least in theory, which proceedings will be sought. As a matter

of practice, however, at the time of commencement of either reorganization or liquidation, it is often impossible to make a final evaluation as to the financial viability of the business. Some of the disadvantages of this approach are that it may create an undesirable degree of polarization between liquidation and reorganization and can result in delay, increased expense and inefficiency, especially, for example, where the failure of reorganization requires a new and separate application to be made for liquidation. This inefficiency can be overcome, to some extent, by providing linkages between the two proceedings, with a view to allowing conversion of one type of proceeding to the other in certain specific circumstances, and by including devices designed to prevent the abuse of insolvency proceedings, such as commencing reorganization proceedings as a means of avoiding or delaying liquidation.

67. As to the question of choice between proceedings, some countries provide that the party applying for the insolvency proceedings will have the initial choice between liquidation and reorganization. When liquidation proceedings are initiated by one or more creditors, the law will often provide a mechanism that enables the debtor to request conversion into reorganization proceedings where feasible. When the debtor applies for reorganization proceedings, whether on its own motion or as a consequence of an application for liquidation by a creditor, the application for reorganization should logically be decided first. With a view to protecting creditors, however, some insolvency laws will provide a mechanism enabling reorganization to be converted into liquidation upon a determination, either at an early stage of the proceedings or later, that reorganization is not likely to, or cannot, succeed. Another mechanism for protection of creditors may consist of setting forth the maximum period for which reorganization against the will of the creditors may be continued.

68. As a general principle, although usually presented as separate, liquidation and reorganization proceedings are normally carried out sequentially; that is, liquidation proceedings will only run their course if reorganization is unlikely to be successful or if reorganization efforts have failed. In some insolvency systems, the general presumption is that a business should be reorganized and liquidation proceedings may be commenced only when all attempts to reorganize the entity have failed. In insolvency systems providing for conversion, a request for reorganization to be converted into liquidation may be made by the debtor, the creditors or the insolvency representative, depending upon the circumstances set forth by the law. These circumstances may include where the debtor is unable to pay post-petition debts as they fall due; where the reorganization plan is not approved by creditors or the court; where the debtor fails to fulfil its obligations under an approved plan; or where the debtor attempts to defraud creditors (see part two, chapter IV). While it is often possible for reorganization proceedings to be converted to liquidation proceedings, most insolvency systems do not allow reconversion to reorganization once conversion of reorganization to liquidation has already occurred.

69. Difficulties of determining at the very outset whether the debtor should be liquidated rather than reorganized have led some countries to revise their insolvency



laws by replacing separate proceedings with “unitary” proceedings.<sup>7</sup> Under the “unitary” approach there is an initial period (usually referred to as an “observation period”, which in existing examples of unitary laws may last up to three months) during which no presumption is made as to whether the business will be eventually reorganized or liquidated. The choice between liquidation or reorganization proceedings only occurs once the financial situation of the debtor has been assessed and a determination made as to whether reorganization is actually possible. The basic advantages offered by this approach are its procedural simplicity, its flexibility and possible cost efficiency. Simple, unitary proceedings may also encourage early recourse to the proceedings by debtors facing financial difficulties, thus enhancing the chances of successful reorganization. A disadvantage of this approach, however, may be the delay that occurs between the decision to commence and the decision as to which proceedings should be followed, and the consequences for the debtor’s business and the value of the debtor’s assets that may flow from that delay. However the insolvency law is arranged in terms of liquidation and reorganization, it should ensure that once a debtor is in the system, it cannot exit without some final determination of its future.

### C. Administrative processes

70. In recent years a number of crisis-affected jurisdictions have developed semi-official “structured” forms of insolvency processes, largely inspired by government or central banks, to deal with systemic financial problems within the banking sector. These processes have been developed on a similar pattern. First, each has a facilitating agency to encourage and, in part, coordinate and administer the process to provide the incentive and motivation necessary for its development. Second, each process is underpinned by an agreement between commercial banks in which the participants agree to follow a set of “rules” in respect of corporate debtors who are indebted to one or more of the banks and which may participate in the process. The rules provide the procedures to be followed and the conditions to be imposed in cases where corporate reorganization is attempted. In some of the jurisdictions, a debtor corporation that seeks to negotiate a reorganization under this process is required to agree to the application of these rules. Third, time limits are provided for various parts of the process and, in some cases, agreements in principle can be referred to the relevant court for reorganization proceedings to commence under the insolvency law. In addition, one jurisdiction established a special agency which has extremely wide powers under its governing legislation to acquire non-performing loans from the banking and finance sector and then to impose extra-judicial processes upon a defaulting corporate debtor, including a forced or imposed reorganization.

71. Both because these processes are relatively complex and involve the development of special rules and regulations and because they address particular situations of systemic failure, they are not discussed in the *Guide*.

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<sup>7</sup> Where a unitary system is chosen, some changes will need to be made to the various core elements of the insolvency law.

### III. Institutional framework

72. An insolvency law is a part of an overall commercial legal system and is heavily reliant for its proper application not only on a developed commercial legal system, but also on a developed institutional framework for administration of the law. The choices made in developing or reforming an insolvency law will therefore need to be closely linked to the capacities of existing institutions. The insolvency system will only be effective if the courts and officials responsible for its implementation have the necessary capacity to provide the most efficient, timely and fair outcome to those for whose benefit an insolvency system exists. If that institutional capacity does not already exist, it is highly desirable that reform of the insolvency law is accompanied by institutional reform, where the costs of establishing and maintaining the necessary institutional framework are weighed against the benefits of providing a system that is efficient, effective and in which the public have confidence. Although a detailed discussion of the means by which this institutional capacity can be developed or enhanced is beyond the scope of the *Guide*, a number of general observations can be made.

73. In most jurisdictions, the insolvency process is administered by a judicial authority, often through commercial courts or courts of general jurisdiction or, in a few cases, through specialized bankruptcy courts. Sometimes judges have specialized knowledge and responsibility only for insolvency matters, while in other cases insolvency matters are just one of a number of wider judicial responsibilities. In a few jurisdictions non-judicial or quasi-judicial institutions fulfil the role that, in other jurisdictions, is played by the courts.

74. In designing the insolvency law it may be appropriate to consider the extent to which courts will be required to supervise the process and whether or not their role can be limited with respect to different parts of the process or balanced by the role of other participants in the process, such as the creditors and the insolvency representative. This is of particular importance where the insolvency law requires judges to deal quickly with difficult insolvency issues (which often involve commercial and business questions) and the capacity of the judiciary is limited, whether because of its size, a general lack of resources in the court system or a lack of specific knowledge and experience of the types of issues likely to be encountered in insolvency.

75. To limit the role to be played by the court, an insolvency law can provide that the representative, for example, is authorized to make decisions on a number of issues, such as verification and admission of claims, the need for post-commencement funding, surrender of secured assets of no value to the estate, sale of major assets, commencement of avoidance actions, and treatment of contracts, without the court being required to intervene, except in the case of a dispute. The use of this approach depends upon the availability of a body of suitably qualified professionals to serve as insolvency representatives. Creditors also can be authorized to provide advice to, or to approve certain decisions of, the insolvency representative, such as approving the sale of important assets or obtaining post-commencement finance, without requiring the court to intervene, except in the case of dispute. An insolvency law can specify those procedures that will require court approval, such as the provision of a priority ranking above the rights of existing secured creditors to secure post-commencement finance.

76. The court's capacity to handle the often complex commercial issues involved in insolvency cases is often not only a question of knowledge and experience of specific law and business practices, but also a question of that knowledge and experience being current and regularly updated. To address the issue of judicial capacity, a special focus on the education and ongoing training of court personnel, not only of judges but also of clerks and other court administrators, will assist in supporting an insolvency regime that has the ability to respond effectively and efficiently to its insolvency caseload.

77. A further consideration related to the court's capacity to supervise insolvency cases is the balance in the insolvency law between mandatory and discretionary components. While mandatory elements, such as automatic commencement or automatic application of the stay, may provide a high degree of certainty and predictability for debtor and creditors, as well as limiting the matters requiring consideration by the courts, it may also lead to rigidity if there are too many of these types of elements. A discretionary approach allows the court to weigh facts and circumstances, taking into account precedent, community interests, and the interests of persons affected by the decision and market conditions. It may also impose a burden on the court where it does not have the knowledge or experience required to weigh these considerations or the resources to respond in a timely manner. Where the insolvency law provides for confirmation of a reorganization plan by the court, for example, it is not desirable to ask the court to undertake complex economic assessments of the feasibility or desirability of the plan, but rather to limit its consideration to the conduct of the approval process and other specified issues. Where an insolvency law requires the exercise of discretion by a decision-maker, such as a court, it is preferable that adequate guidance as to the proper exercise of that discretion also be included, particularly where economic or commercial issues are involved. This approach is consistent with a general objective of an insolvency regime of transparency and predictability.

78. The adequacy of the legal infrastructure and in particular, the resources available to courts dealing with insolvency cases, may be a significant influence on the efficiency with which insolvency cases are handled and the length of time required for insolvency proceedings. This may be a relevant consideration in deciding whether the insolvency law should impose time limits for the conduct of certain parts of the process. If the court infrastructure is not able to respond to the demands placed upon it in a timely manner to ensure that time limits are observed by the parties and the insolvency process is moved quickly along, the inclusion of such provisions in the law will not achieve the goal of an effective and efficient insolvency regime. Procedural rules will also be of importance to the conduct of cases and well-developed rules will assist courts and the professionals handling insolvency cases to provide an effective and orderly response to the economic situation of the debtor, minimizing the delays that can result in diminution in value of the debtor's assets and impair the prospects of a successful insolvency proceedings (whether liquidation or reorganization). Such rules will also assist in achieving a degree of predictability and uniformity of treatment from one case to the next.

79. Implementing an insolvency system depends not only on the court, but also on the professionals involved in the insolvency process, whether they are insolvency representatives, legal advisers, accountants, valuation specialists or other

professional advisers. The adoption of professional standards and training may assist in developing capacity. It may be appropriate to assess which insolvency functions are truly public in nature and which should be performed in the public sector in order to ensure the level of trust and confidence required to make the insolvency system effective, and those functions which can be performed by the creation of adequate incentives for private-sector participants in the insolvency process. The insolvency representative might be one example.

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## Part Two

### Core provisions for an effective and efficient insolvency law

80. Part Two of the Guide focuses on the content of the insolvency law and the core elements that are regarded as necessary for insolvency proceedings conducted under the law to be effective and efficient. As far as possible, the Guide addresses the core elements in a manner that corresponds to the sequence of proceedings.

81. Chapter I analyses application and commencement criteria. Chapter II considers the effects of commencement of insolvency proceedings on the debtor and its assets, including constitution of an insolvency estate, protection and preservation of the estate, use and disposal of assets, post-commencement finance, treatment of contracts, exercise of avoidance provisions, rights of setoff, and financial contracts and netting. Chapter III examines the roles of the debtor and the insolvency representative in insolvency proceedings and their various duties and functions, as well as mechanisms to facilitate creditor participation. While issues relevant to reorganization are considered throughout the Guide, chapter IV examines, in particular, issues relating to the reorganization plan and expedited reorganization proceedings. Chapter V addresses different types of creditor claims and their treatment, as well as establishment of priorities for distribution. Chapter VI deals with issues relating to the resolution of insolvency proceedings, including discharge and closure. [Chapter VII sets forth the UNCITRAL Model Law on Cross-Border Insolvency and its Guide to Enactment.]

#### I. Application and commencement

##### A. Eligibility and jurisdiction

###### 1. Eligibility: debtors to be covered by an insolvency law

82. An important threshold issue in designing an insolvency law focussed on debtors engaged in commercial activities (whether or not they are conducted for profit) is determining and clearly defining which debtors will be subject to the law. To the extent that any debtor is excluded from the law, it will not enjoy the protections offered by the law, nor will it be subject to the discipline of the law. This argues in favour of an all-inclusive approach to the design of an insolvency law, with limited exceptions. The design of eligibility provisions for an insolvency law raises two basic questions. Firstly, whether the law should distinguish between debtors who are natural persons and debtors which are some form of limited liability enterprise or corporation or other legal person, each of which will raise not only different policy considerations, but also considerations concerning social and other attitudes. Secondly, the types of debtors (regardless of the question of whether the debtor is a legal or natural person), if any, that should be excluded from the application of the law.

83. Countries adopt different approaches to defining the scope of application of their insolvency laws. Some insolvency laws apply to all debtors with certain specified exceptions, such as those discussed below. Other countries distinguish

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between natural person debtors and juridical or legal person debtors and provide different insolvency laws for each. A further approach distinguishes between legal and natural persons on the basis of their engagement in commercial (or consumer) activities. Some of these laws address the insolvency of “merchants” which are defined by reference to engagement in commercial activities as an ordinary occupation, or companies incorporated in accordance with commercial laws and other entities that regularly undertake commercial activities. Some laws also include different procedures based on levels of indebtedness, and a number of countries have developed special insolvency regimes for different sectors of the economy, particularly the agricultural sector.

**(a) Individuals engaged in commercial activities**

84. Policies applicable to individual or personal debt and insolvency often evidence cultural attitudes that are not as relevant to commercial debtors and may include, for example, attitudes toward the incurring of personal debt; the availability of relief for unmanageable debt; the social effect of bankruptcy on the status of individuals; the need for counselling and educational assistance with respect to individual debt; and the provision of a fresh start for debtors through a discharge from debts and claims. Policies applicable to insolvency in the commercial sector, in comparison, are generally restricted to economic and commercial considerations such as the important role that business plays in the economy; the need to preserve and encourage commercial and entrepreneurial activity; and the need to encourage the provision of credit and protect creditors.

85. The interests of natural persons involved in commercial activity (including, for example, partnerships of individuals and sole traders) differ from those of consumer debtors, at least in some aspects of their indebtedness, but it is often difficult to separate an individual’s personal indebtedness from their commercial indebtedness for the purposes of determining how they should be treated in insolvency. Different tests may be developed to facilitate that determination, by focussing, for example, upon the nature of the activity being undertaken, the level of debt and the connection between the debt and the commercial activity. Indicators of involvement in commercial activity may include whether the business is registered as a trading or other commercial operation; whether it is a certain type of legal person under the commercial law; the nature of its regular activities; and information concerning turnover and assets and liabilities.

86. Many countries include natural person debtors involved in commercial activity within the scope of their commercial insolvency laws. The experience of other countries suggests that although business activities conducted by natural persons form part of commercial activity, these cases often are best dealt with under the regime for insolvency of natural persons because ultimately the proprietor of a personal business will conduct his or her activities through a structure that does not enjoy any limits on liability, leaving them personally liable, without limitation, for the debts of the business. These cases also raise difficult issues of discharge (release of the debtor from liability for part or all of certain debts after the closure of the proceedings—see chapter VI), including the length of time required to expire before the debtor can be discharged and the obligations which can be discharged or exempted from discharge. Debts which cannot be discharged often involve personal matters such as settlements in divorce proceedings or child support obligations. An

additional consideration is that the inclusion of natural persons in the commercial insolvency regime may have the potential, in some countries, to act as a disincentive to use of the commercial regime because of the social attitude towards personal insolvency, irrespective of its commercial nature. It is desirable that these concerns be considered in designing a law to address commercial insolvency, taking into account the manner in which commercial activity is generally conducted in a particular country and the existence and effectiveness of insolvency laws dealing with natural persons. In many countries, for example, commercial activity is conducted almost exclusively by individuals and to exclude them from the insolvency law would significantly limit its operation and effectiveness. In other countries, insolvency of natural persons engaged in commercial activity is specifically addressed by the personal insolvency law and they are excluded from the commercial regime.

87. This Guide focuses upon the conduct of commercial activities<sup>1</sup> by both legal and natural persons, irrespective of the legal structure through which those activities are conducted, and whether or not they are conducted for profit.<sup>2</sup> It identifies those issues where additional or different provisions will be required if natural person debtors are included in the insolvency law.

**(b) State-owned enterprises**

88. An insolvency law can apply to all forms of debtors engaged in commercial activities, both private and state-owned, especially those state-owned enterprises (SOE) which compete in the market place as distinct commercial or business operations and otherwise have to the same commercial and economic interests as privately-owned businesses. The discussion here is not intended to include states, sub-national governments, municipalities and other similar types of organization or public authority unless they are SOEs operating as commercial enterprises.

89. Government ownership of an enterprise may not, in and of itself, provide a sufficient basis for excluding the enterprise from the coverage of the insolvency law, although a number of countries do adopt that approach. Where the state plays different roles with respect to the enterprise not only as owner, but also as lender and largest creditor, normal commercial incentives will not apply, compromise solutions may be difficult to achieve and there is clear ground for conflicts of interest to arise. Inclusion of these enterprises in the insolvency regime therefore has the advantages of subjecting them to the discipline of the regime, sending a clear signal that government financial support for such enterprises will not be unlimited, and providing a procedure which has the potential to minimise conflicts of interest.

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<sup>1</sup> It is not intended that the Guide should define the phrase "commercial activities". However, should a definition be required, other UNCITRAL texts employing this phrase have adopted a broad interpretation so as to cover matters arising from all relationships of a commercial nature, whether contractual or not. Relationships of a commercial nature include, but are not limited to, the following transactions: any trade transaction for the supply or exchange of goods or services; distribution agreement; commercial representation or agency; factoring; leasing; construction of works; consulting; engineering; licensing; investment; financing; banking; insurance; exploitation agreement or concession; joint venture and other forms of industrial or business cooperation; carriage of goods or passengers by air, sea, rail or road.

<sup>2</sup> It would include, for example, commercial activity conducted for charitable purposes.



90. The need for exceptions to a general policy of inclusion of such enterprises in a general insolvency law may arise where the government has adopted a policy of extending an explicit guarantee in respect of the liabilities of such enterprises, where the treatment of state enterprises is part of a change in macroeconomic policy, such as a large-scale privatization program or where SOEs are involved in sensitive sectors of the economy, such as provision of key services or utilities (e.g. electricity and water). In these cases, independent legislation dealing with relevant issues, including insolvency, may be warranted. The Guide does not address issues specifically relevant to that independent legislation.

**(c) Debtors requiring special treatment**

91. Although it may be desirable to extend the protections and discipline of an insolvency law to as wide a range of debtors as possible, separate treatment may be provided for certain entities of a specialized nature, such as banking and insurance institutions, utility companies, and stock or commodity brokers. Exceptions for these types of debtors are widely reflected in insolvency laws and are generally justified on the basis of the detailed regulatory legal regimes to which these businesses are often subjected outside of the insolvency context. To address the insolvency of such debtors, regulatory regimes can include provisions particular to the type of business being regulated or special rules can be included in the general insolvency law. The special considerations arising from the insolvency of such debtors and consumer insolvency are not specifically addressed in the Guide.

**2. Jurisdiction**

92. In addition to possessing the necessary business or commercial attributes, a debtor must have a sufficient connection to the State to be subject to its insolvency laws. In many cases, no issue as to the applicability of the insolvency law will arise as the debtor will be a national or resident of the State and will conduct its commercial activities in the State through a legal structure registered or incorporated in the State. Where there is a question of the debtor's connection with the State, however, insolvency laws adopt different tests including that the debtor has its centre of main interests in the State, that the debtor has an establishment in the State or that the debtor has assets in the State.

**(a) Centre of main interests**

93. Although some insolvency laws use tests such as principal place of business, UNCITRAL has adopted, in the Model Law on Cross-Border Insolvency ("the UNCITRAL Model Law"), the test of "centre of main interests" of the debtor to determine the proper location for commencement of what is termed the "main proceedings" for that debtor. That test is also used in the Council (EC) Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings ("the EC Regulation"). The UNCITRAL Model Law does not define the term; the EC Regulation (13th Recital) indicates that the term should correspond to "the place where the debtor conducts the administration of his interests on a regular basis and is therefore ascertainable by third parties." An appropriate test would be the one provided in article 16(3) of the UNCITRAL Model Law and article 3 of the EC Regulation: the debtor's registered office, or habitual residence in the case of an individual, is presumed to be the centre of main interests, unless it can be shown that the centre of

main interests is elsewhere. A debtor which has the centre of its main interests in a State should be subject to that State's insolvency law.

94. Notwithstanding the adoption of the "centre of main interests" test, a debtor which has assets in more than one State may find itself satisfying the requirements to be subject to the insolvency law of more than one State because of the different tests of debtor eligibility or different interpretations of the same test, with the resultant possibility of separate insolvency proceedings in those countries. In such cases, it will be appropriate to have in place legislation based on the UNCITRAL Model Law to address questions of coordination and cooperation.<sup>3</sup> In terms of the application of different tests, the Model Law focuses on the primacy of centre of main interests and main proceedings, but recognizes that other tests, such as presence of assets, can be used to commence local "non-main" proceedings to deal with local assets once the foreign main proceedings have been recognized.<sup>4</sup>

**(b) Establishment**

95. Some laws provide that insolvency proceedings may be commenced in a jurisdiction where the debtor has an establishment. The term "establishment" is defined in article 2 of the UNCITRAL Model Law to mean "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services." Article 2 of the EC Regulation includes a similar definition but omits the reference to "services". Essentially, an establishment is a place of business which is not necessarily the centre of main interests. The definition, like the term "centre of main interests", is important to the overall structure of the UNCITRAL Model Law and its treatment of cross-border insolvency cases as a criterion for recognition of foreign insolvency proceedings and the application of measures for relief. In many countries, managers of an establishment that is unable to pay its debts will have personal liability to creditors unless they commence insolvency proceedings. Eligibility to commence proceedings on the basis of an establishment is therefore of relevance to a domestic insolvency regime and the treatment of that debtor's assets in a particular State.

96. The EC Regulation similarly provides that insolvency proceedings may be opened in a jurisdiction where a debtor has an establishment (termed "secondary proceedings"). Generally those proceedings will be restricted to liquidation proceedings covering the assets of the debtor situated in the territory of that State. Depending upon the nature of the debtor's business and the assets concerned, there may be limited situations where reorganization proceedings could be based upon establishment.

**(c) Presence of assets**

97. Some laws provide that insolvency proceedings may be commenced by or against a debtor that has or has had assets within a jurisdiction without requiring the debtor to have an establishment or centre of main interests in the jurisdiction. The UNCITRAL Model Law does not provide for the recognition of foreign proceedings commenced on the basis of presence of assets, although it does provide for local

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<sup>3</sup> The Model Law and Guide to Enactment are included as chapter VII of the Guide.

<sup>4</sup> UNCITRAL Model Law, article 28.

proceedings based on presence of assets to be commenced in a State recognizing foreign main proceedings in order to deal with those local assets.<sup>5</sup>

98. A distinction can perhaps be made between liquidation and reorganization proceedings commenced on the basis of presence of assets; while presence of assets may be an appropriate basis for commencement of liquidation proceedings involving specific assets located in a State, it may not be sufficient for the commencement of reorganization proceedings, particularly where proceedings commenced in the centre of main interests are liquidation proceedings or where the assets in question are limited. Although one country does provide that the presence of assets will be sufficient to commence reorganization proceedings (and that those proceedings can involve the assets of the debtor wherever located), this option is not widely available. Where proceedings are commenced on the basis of presence of assets against a multinational debtor, there generally will be a need to coordinate those proceedings with other jurisdictions where the debtor will have its centre of main interests and possibly establishments. The test of presence of assets may therefore raise multi-jurisdictional issues, including the possibility of multiple proceedings and questions of coordination and cooperation between proceedings that may implicate the UNCITRAL Model Law.

**(d) Competent courts**

99. An additional issue of jurisdiction is the court that is competent to commence insolvency proceedings and to resolve matters arising in the course of those proceedings. The competence for commencement and all later issues arising in the conduct of insolvency proceedings may lie with the same court of a State or different courts will have competence for different issues. To increase the transparency and ease of use of the insolvency law for the benefit of debtors, creditors and third parties (especially where they are from a foreign country), it should be made clear in the law which courts have jurisdiction for which functions. Although provisions specifying which courts have jurisdiction over insolvency proceedings may not always be included in the insolvency law, a reference to the provisions of other law which specifies court jurisdiction might usefully be included in the insolvency law.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on eligibility and jurisdiction is to establish:

- (a) the types of debtors that are subject to the law;
- (b) the types of debtors that may be excluded from the law;
- (c) the debtors that have sufficient connection to a State to be subject to the law; and
- (d) the courts that have jurisdiction over the commencement and conduct of insolvency proceedings.

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<sup>5</sup> UNCITRAL Model Law, article 28 and Guide to Enactment, paras. 184-187; see chapter VII.

## Contents of legislative provisions

### *Eligibility*

- (1) The law should govern insolvency proceedings against all debtors that engage in commercial activities, whether natural or legal persons, including State-owned enterprises,<sup>6</sup> and whether or not those commercial activities are conducted for profit.
- (2) Exclusions from the application of the law should be limited and clearly identified in the law.<sup>7</sup>

### *Jurisdiction*

- (3) The law should specify which debtors have sufficient connection to a State to be subject to its application. Different approaches may be taken to identifying appropriate connecting factors, but the grounds upon which a debtor can be subject to the law should include:<sup>8</sup>
  - (a) that the debtor has its centre of main interests in the State; or
  - (b) that the debtor has an establishment in the State.
- (4) The law should establish a presumption that, in the absence of proof to the contrary, a legal person's centre of main interests is in the State in which it has its registered office, and a natural person's centre of main interests is in the State in which it has its habitual residence.
- (5) The law should define "establishment" to mean "any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services".<sup>9</sup>
- (6) The law should clearly indicate (or include a reference to the relevant law which establishes) the court that has jurisdiction over the commencement and conduct of insolvency proceedings, including matters arising in the course of those proceedings.

## B. Commencement of proceedings

### 1. Introduction

100. The commencement standard is central to the design of an insolvency law. By providing the basis upon which insolvency proceedings can be commenced, this

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<sup>6</sup> It is not intended that the legislative guide would apply to the insolvency of States, sub-national governments, municipalities and other similar types of organization, except to the extent that they are a "state-owned enterprise".

<sup>7</sup> Highly regulated organizations such as banks and insurance companies may require specialized treatment which can appropriately be provided in a separate insolvency regime or through special provisions in the general insolvency law. Some SOEs, such as those involved in sensitive sectors of the economy might also be excluded.

<sup>8</sup> This recommendation is intended to indicate minimum and non-exclusive grounds for commencing insolvency proceedings. Other grounds, such as presence of assets, are used in some jurisdictions: see the discussion in chapter I.A.2 (c). and paras. 184-187 of the Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency, included in chapter VII.

<sup>9</sup> UNCITRAL Model Law on Cross-Border Insolvency art. 2(f).

standard is instrumental to identifying the debtors that can be brought within the protective and disciplinary mechanisms of the insolvency law and determining who may make an application for commencement, whether the debtor, creditors or other parties.

101. As a general principle it is desirable that the commencement standard is transparent and certain, facilitating access to insolvency proceedings conveniently, cost-effectively and quickly to encourage financially distressed or insolvent businesses to voluntarily commence proceedings. It is also desirable that access is flexible in terms of the types of insolvency proceedings available (reorganization and liquidation), the ease with which the proceedings most relevant to a particular debtor can be accessed and conversion between the different types of proceedings can be achieved. Restrictive access can deter both debtors and creditors from commencing proceedings, while delay can be harmful in terms of its effect on the value of assets and the successful completion of insolvency proceedings, particularly in cases of reorganization. Ease of access needs to be balanced with proper and adequate safeguards to prevent improper use of proceedings. Examples of improper use may include application by a debtor that is not in financial difficulty in order to take advantage of the protections provided by the law, such as the automatic stay, or to avoid or delay payment to creditors and application by creditors who are competitors of the debtor, where the purpose of the application is to take advantage of insolvency proceedings to disrupt the debtor's business and thus gain a competitive edge.<sup>10</sup>

102. Laws differ on the specific standard that must be satisfied before insolvency proceedings can commence. A number of laws include alternative standards, and distinguish between the standard applicable to commencement of liquidation and reorganization proceedings, as well as between applications by a debtor and creditors.

## **2. Commencement standards**

### **(a) Liquidity, cash flow or general cessation of payments test**

103. A standard that is used extensively for commencement of insolvency proceedings is what is known as the liquidity, cash flow or general cessation of payments test. This requires that the debtor has generally ceased making payments and will not have sufficient cash flow to service its existing obligations as they come due in the ordinary course of business. Indicators of a debtor's general cessation of payments may include its failure to pay rent, taxes, salaries, employee benefits, trade accounts payable and other essential business costs. As such, this test puts the defining factors within the reach of creditors. Reliance on this test is designed to activate insolvency proceedings sufficiently early in the period of the debtor's financial distress to minimize dissipation of assets and avoid a race by creditors to grab assets that would cause dismemberment of the debtor to the collective disadvantage of all creditors. Allowing commencement of proceedings to take place only when the debtor can demonstrate balance sheet insolvency (when

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<sup>10</sup> This is discussed further in the context of denial of the commencement application and discontinuation of proceedings, part two, chapter I.B.5(d) and 8.

the debtor's balance sheet shows that the value of its liabilities exceed its assets—discussed below), may only serve to delay the inevitable and diminish recoveries.

104. One issue associated with the general cessation of payments test that needs to be considered is that the inability of the debtor to pay its debts as they become due may point to only a temporary cash flow or liquidity problem in a business that is otherwise viable. In today's competitive markets, competition may compel market participants to accept ever lower profits or even losses on a temporary basis in order to become competitive and maintain or gain market share. While it will be a question of fact in each case, it is desirable that an insolvency law provides guidance for the court in determining whether or not the commencement standard has been met in order to avoid a premature finding of insolvency.

**(b) Balance sheet test**

105. An alternative standard to general cessation of payments would be the balance sheet test, which is based on excess of liabilities over assets as an indication of financial distress. Since it relies on information under the control of the debtor, a practical limitation of the balance sheet test is that it is rarely possible for other parties to ascertain the true state of the debtor's financial affairs until after these difficulties have become a settled and often irreversible fact, and it thus may not easily form the basis for a creditor application. In addition, it may give a misleading indication of the debtor's financial situation because it focuses upon what is essentially an accounting question of how assets should be valued (e.g. a liquidation value as against a going concern value) and raises questions of whether a debtor's balance sheet is reliable and whether it gives a true indication of the debtor's ability to pay, particularly where accounting standards and valuation techniques give rise to results that do not reflect the fair market value<sup>11</sup> of a debtor's assets or where markets are not sufficiently developed or stable to enable that value to be established. This may be particularly true in the case of service businesses that under this test may technically be insolvent because of a lack of assets, even when the business is essentially viable. Alternatively a business may have a positive balance sheet without the cash flow necessary to sustain the business.

106. This test can also lead to delay and difficulties of proof as an expert would generally be required to review books, records and financial data<sup>12</sup> to reach a

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<sup>11</sup> Fair market value is generally considered to be the value that reasonably can be expected to be obtained in an arm's length sale between a buyer and a seller, where neither party is under a compulsion to buy or sell. In the absence of a real sale, value may be somewhat speculative, as values are based on assumptions made regarding the conditions for the sale of the assets in question. To reduce the speculation, techniques have been developed to approximate value on the basis of sale of comparable businesses and assets, or on the basis of a multiple of the enterprises earnings potential. In markets where assets cannot be easily sold, because the market is saturated or because a market for the assets in question does not exist, value is difficult to measure.

<sup>12</sup> The book value of an asset is the amount for which the asset is shown for accounting purposes. It is usually derived from the original acquisition value which is adjusted for a combination of depreciation, amortization, revaluation to any lower current market price or, occasionally, revaluation upwards in accordance with accounting principles. Although there are generally accepted accounting principles ("GAAP") expounded by the International Accounting Standards Board, it is important to note that there are no universally agreed accounting guidelines that dictate the basis on which assets should be valued for accounting purposes. Furthermore, the

determination of the entity's fair market value. This will be especially difficult where those records are not properly maintained or readily available. For these reasons the balance sheet test often leads to proceedings being commenced after the possibilities of reorganization have disappeared, and can negatively affect the debtor's ability to deal collectively with its creditors when it maintains an operating business, thus circumventing the objective of maximization of value. It will thus not be sufficiently reliable to constitute the sole basis of that definition and it may be desirable to use it in conjunction with the cessation of payments test. When used in that manner, the balance sheet test can assist in defining insolvency by focusing on whether the assets, however valued, will be sufficient to satisfy the debtor's liabilities, including those obligations that are not yet mature.

**(c) Designing the commencement standard**

107. Insolvency laws use the general cessation of payments test and the balance sheet test in different combinations to establish a commencement standard. Some laws adopt a simple form of the general cessation of payments test, requiring that the debtor be unable to meet its obligations as they fall due. Other laws adopt that test but add further requirements, for example, that the cessation of payments must reflect a difficult financial situation that is not temporary, that the creditworthiness of the debtor must be at stake and that it be just and equitable for the debtor to be liquidated. The more elements are added to the commencement standard, the more difficult they will be to satisfy, especially where the elements included are subjective. This may lead to applications being contested, causing delay, uncertainty and expense. By contrast, tests that are relatively simple and straightforward may have a tendency to include more cases, but this may be balanced by the increased ease of application that results from such tests.

108. Another approach combines the cessation of payments test with the balance sheet test. One example requires that, in addition to having ceased making payments, the debtor must be overindebted, where overindebtedness is determined, for example, by the debtor's inability to satisfy its debts as they become mature because its liabilities exceed its assets. An approach that combines the two tests may support commencement where there is a lack of information as to the existence of a general default and provide a more complete picture of the debtor's present and prospective financial situation. The balance sheet test may facilitate, for example, consideration of immature debt that would not otherwise be considered under the cessation of payments test, but which will be very relevant, for example, to the likely success of reorganization.

109. An insolvency law may adopt a single standard for insolvency, in which case the cessation of payments test provides an efficient trigger for access to insolvency proceedings; the balance sheet test, as noted above, suffers from a number of disadvantages and should not be used as the single test. An insolvency law may also adopt a standard that contains both the cessation of payments test and the balance sheet test. Where this approach is followed, proceedings can be commenced if either of the tests can be satisfied.

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book value of assets for management account purposes may not be the same as the values for which the same assets are included in year-end audited financial statements. The result is that the book values of assets may bear little or no relationship to the amounts for which they could be realized to satisfy creditors.

(i) *Imminent insolvency (prospective illiquidity)*

110. Some laws which adopt only a cessation of payments test also make provision for a debtor to apply for commencement on the basis of imminent insolvency or prospective inability to pay, where the debtor will be unable to meet its future obligations as they fall due. While in some cases the prospective inability might relate to a short period into the future, there may be cases where it will relate to a significantly longer term, depending upon the nature of the obligation to be met. Factual circumstances which could establish prospective inability might include that the debtor has a long term obligation to make a bond payment that it knows it will not be able to make, or that it is the defendant to a mass tort claim that it knows it cannot successfully defend and that it will be unable to pay the associated damages.

(ii) *Types of proceedings that may be commenced*

111. A second dimension of the commencement standard is the type of proceeding that can be commenced (see also part one, chapter II). In some laws the commencement standard, whether based on general cessation of payments or the balance sheet test, provides the basis for commencement of either liquidation or reorganization proceedings. Where the liquidation application is made by a creditor, the insolvency law may permit the debtor to apply for the proceedings to be converted from liquidation to reorganization. Under other insolvency laws where reorganization is favoured, reorganization proceedings must be commenced, but can be converted to liquidation when it is shown that the debtor cannot be reorganized. Under a further approach, the effect of the application is neutral and the choice between liquidation and reorganization will only be made after a period of assessment of the debtor's financial situation.

### **3. Liquidation**

(a) **Parties who may apply**

112. Insolvency laws generally permit an application for liquidation proceedings to be made by the debtor, by one or more creditors or a government authority, or by operation of law where the failure by the debtor to meet some statutory requirement (such as maintenance of a specified level of assets) automatically triggers insolvency proceedings.

(b) **Debtor application**

113. Many insolvency laws adopt a general cessation of payments test for debtor applications for liquidation. Since, as a matter of practice, an application by a debtor to commence liquidation proceedings will generally be a last resort in situations of severe financial difficulty, some laws allow a debtor to make an application either on the basis that it has ceased to repay its debts as they become due or, in the alternative, on the basis of a simple declaration of its financial condition, such as that it is unable or does not intend to pay its debts (in the case of a legal person the declaration may be made by the directors or other members of a governing body). At least one insolvency law dispenses with the need for the debtor to allege any particular financial state. In such cases, whatever burden of proof is placed on the debtor, the insolvency law should distinguish between, and provide for, on the one hand, situations where acceptance of the debtor's financial declaration can be



assumed provided no objections are raised by creditors and, on the other, situations where the debtor should be questioned as to its financial circumstances because there is some doubt regarding its financial situation or because creditors have raised objections to the commencement of proceedings. To some extent, these issues can be addressed by the procedure for commencement of proceedings. Where the court is required to make the commencement decision, for example it will have the opportunity to review the application and creditors can raise objections at that hearing. Where the application functions to automatically commence proceedings, creditors and other interested parties will still have the opportunity to raise objections, albeit after the commencement of proceedings (see 5(b) and 8 below). In both cases, attempts to misuse the application procedure can be reviewed.

(i) *Establishing an obligation for debtor to apply*

114. A matter related to debtor applications is the question of whether or not the debtor should have an obligation to make an application for commencement of proceedings at a certain stage of its financial difficulty. There is no widely agreed approach to this issue. Some insolvency or business governance laws include provisions that require the debtor to make an application within a period of time (varying from two weeks to 60 days) after being unable to pay its debts as they become due or after learning of its overindebtedness determined by reference to its balance sheet. Some laws specify how cessation of payments is to be determined which may include, for example, by reference to bank records that show that the debtor has failed to pay a certain percentage of its aggregate debts for a certain period of time, such as two months. In the case of liquidation, the imposition of such a duty may protect creditors' interests by preventing further dissipation of the debtor's assets and, in the case of reorganization, increase the chances of success by encouraging early action. This may be important in countries where there is no active creditor class that can be relied upon to commence proceedings. Experience in some countries suggests, however, that imposing an obligation on the debtor to apply after a certain number of days or weeks of inability to pay or cessation of payments simply leads to debtor applications which do not reflect a true position of insolvency (and thus a real need for liquidation or reorganization). In some countries it has also placed additional strain on the insolvency infrastructure where it may not have been sufficiently developed to handle a large number of such applications following the imposition of such an obligation.

115. Establishing such an obligation may also raise difficult practical questions of how and when it should apply, particularly where a delay in applying for formal proceedings could lead to personal liability of members of the debtor, its governing body or its managers. In those circumstances it may operate to discourage the debtor from pursuing alternative solutions to its financial difficulties, such as an out-of-court reorganization agreement, which may be a more appropriate alternative in particular cases.<sup>13</sup> In addition, an obligation to apply will be of no effect where it is not combined with enforceable (and enforced) sanctions for the failure to comply. The adoption of incentives (such as the application of a stay to protect the debtor against enforcement and other actions—see chapter II.B) may be a more effective

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<sup>13</sup> This issue is discussed further in the context of expedited reorganization proceedings and the relevant commencement criteria, see part two, chapter IV.B

means of encouraging debtors to initiate proceedings at an early stage than the imposition of sanctions for failure to meet the obligation to apply.

**(c) Creditor application**

116. Many insolvency laws also adopt a cessation of payments requirement for creditor applications for liquidation of a debtor, often with the additional requirement that a significant portion of the debt be undisputed and free of offset. In a few laws, the debt must be based upon a court judgement. Where a test of general cessation of payments is adopted for creditor applications, problems of proof may arise. While individual creditors may be able to show that the debtor has failed to pay their own claim or claims, providing evidence of a general cessation of payments may not be so easy. There is a practical need for a creditor to be able to present proof, in relatively simple form, which establishes a presumption of insolvency of the debtor, without placing an unreasonably heavy burden of proof on creditors. To refine the test of general cessation of payments in order to establish a threshold of proof that creditors may satisfy, a reasonably convenient and objective test may be the failure of a debtor to pay a matured debt within a specified period of time after a written demand for payment has been made, or a specified time after the debt became due. A number of insolvency laws include such provisions, with the specified time in those cases where a formal demand is required ranging from eight days to 24 weeks. Some insolvency laws also include provision for the application to be based upon an unsuccessful debt recovery action that took place within a specified period of time, such as three months, before the application for commencement is made. Where time periods are to be included in the law, it may be desirable, in order to satisfy the key objectives of quick access to insolvency proceedings and preservation of value, for relatively short periods to be specified.

117. Creditors holding unmatured claims also have a legitimate interest in the commencement of insolvency proceedings. A particular concern may arise, for example, in the case of holders of long-term debt. Where the test is one of maturity of debt those creditors might never be eligible to seek commencement of proceedings, although it may be clear that the debtor will be unable to meet the relevant obligation when the time comes. One approach might be for an insolvency law to provide that the failure to pay an instalment of long-term debt could form the basis of a creditor application. However, developing a test that would allow an application in those circumstances may raise difficult issues of proof, particularly as to how the failure to make a single payment relates to the debtor's financial status. If an insolvency law were to permit applications to be made by creditors not holding mature debt, those issues of proof would need to be balanced against the objective of convenient, cost-effective and quick access to insolvency proceedings. These issues could be addressed by using a standard that contains both the cessation of payments and balance sheet tests.

118. In addition to the requirements for cessation of payments, maturity of the debt and that the claim be undisputed, some insolvency laws include other requirements, for example that the application be made by more than one creditor (each of which may be required to be an unsecured creditor holding an undisputed claim); and that creditors not only hold mature claims, but that their claims represent a specified composite value of claims (or a combination of both a specified number of creditors and a composite value of claims).

119. These requirements are often based upon the desire to minimise possible improper use by a single creditor who may seek to use the insolvency process as a substitute for a debt enforcement mechanism, particularly where the debt in question is small, or by a small number of creditors whose debt is only a fraction of the debtor's total indebtedness. The arguments in favour of such an approach may need to be balanced, however, against the objective of facilitating quick and easy access to the insolvency process. The concerns with improper use may be addressed by taking into account the value of the claim of the single creditor (although specifying a particular value for claims may not always be an optimal drafting technique as currency fluctuations may necessitate amendment of the law) or adopting a procedure which requires the debtor to provide information to the court that will enable the court to determine whether non-payment of a debt is the result of a dispute with a particular creditor or is, in fact, evidence of a lack of liquid assets. Concerns with improper use can also be addressed by focussing on discouraging improper use, rather than upon constructing a complex commencement standard to the potential detriment of all eligible debtors, and providing for certain consequences, such as damages for harm done to the debtor. These damages may relate not only to the costs and expenses incurred by the debtor, but also to disruption to the debtor's business.

**(d) Application by a governmental authority**

120. Where the government is a creditor, it should have the same right as any other creditor to initiate liquidation proceedings. That right is generally given to a specific government (normally the public prosecutor's office or the equivalent) or other supervisory authority and the same commencement standard as applies in the case of applications by other creditors should generally apply.

121. Some countries provide an additional more broadly-based power for government or other supervisory authorities to use the insolvency regime to shut down a business in circumstances where the authority is not necessarily a creditor but closure of the business is considered to be in the public interest. In that case, a demonstration of illiquidity is not always necessary, enabling the government to terminate the operations of businesses that have been engaged in certain activities, generally of a fraudulent or criminal nature or involving serious breach of regulatory obligations or a combination of these. Given the potential for such a power to be misused in circumstances unrelated to insolvency and for public interests grounds to be very broadly defined, it is highly desirable that such powers be available only in very limited circumstances and only as a last resort in the absence of appropriate remedies under other laws. These limited circumstances may include the use of insolvency powers in conjunction with enforcement of laws, such as laws relating to money-laundering or regulation of securities, where a demonstration of insolvency may not be required. They may also include circumstances involving actual indications of insolvency where, for example, the authority is acting in the interests of a large number of small creditors, none of whom has a large enough debt to justify applying for proceedings, but who are nevertheless being harmed by the activities of the debtor.

122. Certain protections may also be required where the insolvency regime is to be used in these ways. For example, a preliminary investigation of the affairs of the debtor may be required; and preliminary measures, such as application of a stay and

appointment of an interim insolvency representative, may be granted to prevent the possibility of impropriety pending the court's determination as to what further action should be taken with respect to the business. The additional powers discussed above would generally only be available to commence liquidation proceedings, although there may be exceptional circumstances where liquidation could be converted to reorganization, subject to certain controls. These controls might include that the business activity is lawful and that management of the debtor's business is taken over by an insolvency representative or governmental agency.

#### **4. Reorganization**

##### **(a) Parties who may apply**

123. To a greater extent than with applications to commence liquidation proceedings, insolvency laws take different approaches to who may apply to commence reorganization proceedings, and a number of laws only permit debtor applications.

##### **(b) Debtor application**

124. One of the objectives of reorganization proceedings is to establish a framework that will encourage debtors to address their financial difficulties at an early stage to enable the business to continue to the benefit of the debtor and creditors alike. A commencement standard which is consistent with that objective may be one which is more flexible than the commencement standard for liquidation and does not require the debtor to wait until it has ceased making payments generally before making an application, but allows an application in financial circumstances which, if not addressed, will result in a state of insolvency. Approaches to debtor applications for reorganization vary between insolvency laws. In some laws, the reorganization procedure does not actually require the satisfaction of any substantive standard: the debtor may make an application whenever it wishes and is only required to file a simple petition in the appropriate court. Other laws, including those that adopt a unitary approach (see part one, chapter II.D), specify that the debtor may make an application if it envisages that, in the future, it will not be in a position to pay its debts when they come due (prospective or imminent insolvency or illiquidity). A number of reorganization laws also require evidence of a real or reasonable prospect of survival of the debtor or of the economic viability of the debtor.

125. It might be suggested that a relaxation of the commencement standard could invite abuse of insolvency proceedings. For example, a debtor that is not in financial difficulty might apply to commence proceedings and submit a reorganization plan that is designed to allow it to shed onerous obligations, such as labour contracts, to allow it to renegotiate its debt or to prevaricate and deprive creditors of prompt payment of debts in full. This situation should be distinguished from those situations in which debtors should be encouraged to apply because, for example, the payment of mature debts caused financial hardship which could lead to insolvency and the debtor could satisfy a test of imminent insolvency or prospective illiquidity (see chapter I.B.2(c)(i) above), even if it were not actually insolvent at the time of making the application. In other words, there is a financial basis for the application. Whether such improper use could arise is a question of how the elements of the reorganization procedure are designed, including the commencement standard,

requirements for preparation of the reorganization plan, debtor control of the business after commencement and sanctions for improper use of the process. As noted above, it may be desirable that the insolvency law focuses upon discouraging improper use rather than making commencement more difficult to the potential detriment of all eligible applicants. Improper use by the debtor could be addressed by providing, for example, that the relevant court has the power to deny the application and, in that event, that the debtor should be liable to creditors for their costs associated with resisting the application and for any harm caused by the application.

**(c) Creditor application**

126. Although insolvency laws generally provide for liquidation proceedings to be initiated by either a creditor or a debtor, there is no consensus as to whether reorganization proceedings can also be initiated by a creditor and, as noted above, a number of laws include provision only for debtor applications. Given that one of the objectives of reorganization proceedings is to enhance the value of assets and thereby increase the return to creditors on their claims through the continued operation and reorganization of the debtor's business, it is desirable that the ability to apply not be given exclusively to the debtor. A further reason for allowing creditor applications is that there will be cases where the debtor will not or can not apply for commencement because, for example, management has resigned. The ability of creditors to apply for reorganization is also central to the question of whether creditors can propose a reorganization plan (see chapter IV). A number of countries take the position that, since in many cases creditors are the primary beneficiaries of a successful reorganization, creditors should have an opportunity to propose the plan. If that approach is followed, it seems reasonable to provide that creditors can also make an application for commencement of reorganization proceedings.

127. In insolvency laws that permit creditors to apply for reorganization of a debtor, different approaches are taken to the commencement standard. One approach is those insolvency laws which adopt the same test, including prospective illiquidity, as applies in the case of a debtor application for reorganization. A different approach regards use of the same test as difficult to justify. This is not only because of the difficulties associated with creditors being able to prove that a standard of prospective illiquidity has been met by the debtor, but also because, as a general matter, it would seem unreasonable for any form of insolvency proceeding to be commenced against the debtor's will, unless creditors can demonstrate that their rights already have been impaired.

128. To address these issues with respect to creditor commencement of reorganization proceedings, some laws adopt commencement standard which require creditors to demonstrate certain factors in addition to insolvency. For example, that ongoing cash will be available to pay for the day to day running of the business, that the value of the assets will support reorganization and that the return to creditors in a reorganization is likely to exceed the return in liquidation. One clear disadvantage of such approaches is that they require creditors to have made, or be able to make, a thorough assessment of the business before making an application. That assessment may rely in turn upon obtaining information from the debtor that is relevant to that assessment and reliable enough to facilitate such

assessment. These concerns can be addressed by providing, for example, that on the making of an application by creditors, an assessment of the debtor's financial situation will be undertaken by an independent authority. Such a procedure may have the advantage of ensuring that proceedings are only commenced in appropriate cases. Care may be needed to ensure, however, that the additional requirements do not serve to complicate the application procedure, discouraging creditors from proposing reorganization, and promoting liquidation as an easier alternative or delaying commencement of the proceedings with consequences for maximization of value of the assets and affecting the likelihood of successful completion of the reorganization. Care should also be taken to ensure that the insolvency context is not used by a competitor of the debtor to obtain commercially sensitive or confidential information or to disrupt its business by imposing unjustifiable requirements with regard to assessment of its financial position.

129. Some insolvency laws adopt a variation of the cessation of payments test, and require the application to be made by a specified number of creditors or by creditors holding a specified value of matured claims, or both. Other laws require creditors, on making an application, to provide a bond or payment to cover the costs of the commencement proceedings.<sup>14</sup> These requirements might be said to suffer from the same disadvantages as noted above in respect of requirements that sufficient means are available to achieve a successful reorganisation.

130. The question of the complexity or simplicity of commencement standards is closely linked to the consequences of commencement and the conduct of the insolvency proceedings. In insolvency laws that apply a stay automatically on commencement of the proceedings, for example, the ability of the business to continue trading and be successfully reorganized can be assessed after commencement (and conversion of the proceedings to liquidation can occur if reorganization is determined to be inappropriate, where the law allows this course). In other systems, that information may be needed before an application is made because the choice of reorganization presupposes that it will lead to a greater return for creditors than liquidation.

131. For the reasons discussed in the paragraphs above, it may be appropriate to apply the same commencement standard to applications by creditors for both liquidation and reorganization of a debtor (i.e. a general cessation of payments test). Such a standard would appear to be consistent with both the two-track approach and the unitary approach (see part one, chapter II.D), where the application of a different commencement standard is not so much a function of the type of proceedings being initiated, but rather whether the applicant is the debtor or a creditor. The exception to the approach of having the same commencement standard for both liquidation and reorganization would be those systems which favour reorganization and where both a debtor and a creditor are precluded from initiating liquidation proceedings until it has been determined that reorganization is impossible. In that case, the commencement standard for liquidation would not be a general cessation of payments, but rather a determination that reorganization cannot succeed.

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<sup>14</sup> Such a payment may also provide remuneration for the insolvency representative (see part two, chapter III.B, and see also the discussion on costs of the insolvency proceeding part two, chapter I.B.6).

## **5. Procedural issues**

### **(a) Making an application for commencement**

132. The insolvency law should specify how the insolvency proceedings could be commenced. Many insolvency laws require an application to be filed with a specified court, although there are other examples such as a law that provides for the proceedings to be initiated by lodgement of a declaration by the debtor with the corporate regulatory authority. This raises the question of the involvement of the court in the insolvency process, which is discussed in part one. Law other than the insolvency law may also affect the way in which the insolvency process is commenced, such as constitutional law (which may be relevant, for example, to the role of courts and administrative agencies, and to issues of competence), procedural law (including court rules) or company law.

### **(b) The decision to commence insolvency proceedings**

133. A preliminary procedural issue relates to the manner in which the proceeding is commenced once the application has been made. In many countries the normal practice is for a court of competent jurisdiction to determine, on the basis of the application, whether the requisite conditions for commencement have been met. In some countries, that determination can also be made by the appropriate administrative agency or tribunal, where that agency plays a central supervisory role in the insolvency process. The central issue, however, is not so much who makes the decision to commence proceedings but rather what that body is required to do in order to approve an application and for proceedings to commence. Entry conditions which are designed to facilitate early and easy access to the insolvency process not only will facilitate the consideration of the application by the court or other body by reducing complexity and, where appropriate, assisting it to reach a decision in a timely manner, but also have the potential to reduce the cost of proceedings and increase transparency and predictability. Such entry conditions are also less likely to place a burden on systems which may lack institutional capacity or the expertise to undertake complex investigations requiring considerable commercial and business expertise. The issue of the costs and fees associated with accessing insolvency proceedings may be of particular importance in the case of small and medium size businesses. A further factor to be noted with respect to the commencement procedure is a recent trend in several insolvency laws of recognizing that the debtor has a fundamental right to be heard by the court or body that would determine an application for commencement of proceedings, whether the application was made by a debtor or by creditors.

134. In addressing requirements for commencement, some insolvency laws draw a distinction between an application by a debtor and an application by a creditor. In some laws, an application by a debtor functions as an acknowledgement of insolvency and leads to an automatic commencement of proceedings, unless it can be shown that the insolvency law is being abused by the debtor. In contrast, in the case of an application by a creditor under these laws, a court is required to consider whether the commencement criteria have been met before deciding to commence the proceedings. A primary reason is to avoid abuse by creditors or other interested parties. In some other laws, irrespective of whether the application is made by a debtor or creditors, the court is required not only to determine whether the entry

conditions have been met, but also to determine whether the type of proceedings applied for is appropriate to the particular circumstances of the debtor.

135. If the assessment to be made is complex there is a potential not only for delay between application and commencement, but also for further debts to be incurred in that period, as the debtor continues to trade and allows trade debts to increase in order to preserve cash flow, and for assets to be dissipated by the actions of creditors. Where the court is required to assess various issues before proceedings can be commenced, one means of reducing the potential complexity of the assessment is to provide, firstly, for the assessment to be made after commencement when the court can be assisted by the insolvency representative and other experts and, secondly, for conversion between liquidation and reorganization. Where this approach is adopted, an insolvency law may need to provide clear rules regarding the application of the stay (see chapter II.B), priority for repayment of debts incurred (see chapter V.C.1(b)) and the debtor's authority to dispose of assets during this period (see chapter II.A.2), as well as the treatment of unauthorized transactions occurring during the assessment period (see chapter II.F).

**(c) Establishing a time limit for making the commencement decision**

136. Where a court is required to make a decision as to commencement, it is desirable that that decision be made in a timely manner to ensure both certainty and predictability of the decision-making process and the efficient conduct of the proceedings without delay. This will be particularly important in the case of reorganization to avoid further diminution of value of the assets and to improve the chances of a successful reorganization. Some insolvency laws prescribe set time limits for the period after the application within which the decision to commence must be made. These laws often distinguish between applications by debtors and by creditors, with applications by debtors tending to be determined more quickly. Any additional period for creditor applications is to allow for prompt notice to be given to the debtor and to provide the debtor with an opportunity to respond to the application.

137. Although the approach of fixing time limits may serve the objectives of providing certainty and transparency for both the debtor and creditors, the achievement of these objectives may need to be balanced against possible disadvantages. For example, a fixed time limit may be insufficiently flexible to take account of the circumstances of the particular case. It may establish an arbitrary limit which takes no account of the resources available to the body responsible for supervision of insolvency proceedings or of the local priorities of that body (especially where insolvency is only one of the matters for which it has responsibility). It may also prove difficult to ensure that the decision-making body adheres to the established limit and to provide appropriate consequences where there is no compliance. The time period between application and the decision to commence proceedings should also reflect the type of proceedings applied for, the application process, and the consequences of commencement in any particular regime. For example, the extent to which notification of interested parties and information gathering must be completed prior to commencement will vary between regimes, requiring different periods of time. For these reasons, it is desirable that an insolvency law adopt a flexible approach that emphasizes the advantages of quick



decision-making and provides guidance as to what is reasonable, but at the same time also recognizes local constraints and priorities.

**(d) Denial of the application to commence**

138. The preceding paragraphs refer to a number of instances where it will be desirable, in those cases where the court is required to make the commencement decision, for the court to have the power to deny the application for commencement, either because of questions of improper use of the insolvency law or for technical reasons relating to satisfaction of the commencement standard. The cases referred to include examples of both debtor and creditor applications. Principal amongst the grounds for denial of the application for technical reasons might be those cases where the debtor is found not to satisfy the commencement standard; where the debt is subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt; where the proceedings will serve no purpose because, for example, secured debt exceeds the value of assets; and where the debtor has insufficient assets to pay for the insolvency administration and the law makes no other provision for the administration of such estates.

139. Examples of improper use might include those cases where the debtor uses an application for insolvency as a means of prevaricating and unjustifiably depriving creditors of prompt payment of debts or of obtaining relief from onerous obligations, such as labour contracts. In the case of a creditor application, it might include those cases where a creditor uses insolvency as an inappropriate substitute for debt enforcement procedures (which may not be well developed); to attempt to force a viable business out of the market place; or to attempt to obtain preferential payments by coercing the debtor (where such preferential payments have been made and the debtor is insolvent, investigation would be a key function of insolvency proceedings).

140. As noted above, where there is evidence of improper use of the insolvency proceedings by either the debtor or creditors, the insolvency law may provide, in addition to denial of the application, that sanctions can be imposed on the party improperly using the proceedings or that that party should pay costs and possibly damages to the other party for any harm caused. Remedies may also be available under non-insolvency law.

**(e) Notice of application and commencement**

141. Giving notice of an application for commencement and of the commencement of insolvency proceedings is central to several key objectives of an insolvency regime. It ensures the transparency of the process and that all affected parties—the creditors in the case of a debtor application, and the debtor in the case of a creditor application—are equally well-informed

*(i) Debtor applications—notice to creditors*

142. In the event of a debtor application, creditors and other interested parties have a direct interest in receiving notice of the proceedings and an opportunity to dispute the presumptions of eligibility (perhaps within a specified time period to prevent the proceedings from being prolonged unnecessarily). The question arises, however, as to the time at which creditors should be notified—at the time the application is

made or the time the proceedings commence. The interests of creditors in knowing that the application has been made may need to be balanced, in certain circumstances, against the possibility, that if notice of the application is provided, the business position of the debtor may be unnecessarily affected where the application is ultimately rejected or creditors may be encouraged to take last minute action to enforce their claims. These concerns may be addressed by providing generally that creditors will be notified only of commencement of the proceedings. A further concern might relate to the consequences for creditors of a delay between the time of application by a debtor and the commencement of proceedings where they are only notified of the commencement. In that interim period, creditors will have an interest in being notified of the application in order to be able to make an informed decision concerning continuing provision of goods and services to the debtor to avoid the accumulation of further debt. Whilst it might be possible to adopt a flexible notice provision that would allow the court to provide notice in such circumstances, it might be better addressed in the insolvency law by reference to the timing of the commencement decision and the need to avoid delay.

(ii) *Creditor applications—notice to the debtor*

143. In the event of a creditor application for commencement of insolvency proceedings it is increasingly recognized that the debtor should have a fundamental right to immediate notice of the application and should have an opportunity to be heard and to dispute the applicants claims as to its financial position (see chapter III.A.3). Where the debtor has disappeared or is avoiding receiving personal notice, requirements for public notification might suffice, or notice could be served at the last known address of the debtor. Nevertheless, there may be exceptional circumstances where provision could be made, with the consent of the court, for personal notice to the debtor to be dispensed with on the basis that it may thwart the purpose of a particular application. These circumstances may include cases where giving notice of the application may lead to assets being placed by the debtor beyond the reach of the creditors or the insolvency representative. The counter-argument is that where the debtor is not notified, it could unknowingly continue to act to the detriment of the value of its assets and thus creditors. This concern may be better addressed in terms of provisional measures such as the imposition of a stay than by dispensing with notice of the application. However, where the law does permit the court to dispense with notice of the application, the debtor should nevertheless receive notice of commencement of proceedings as soon as possible.

(iii) *Notice of commencement to parties other than creditors*

144. There may be a number of parties other than creditors who may require notice of the commencement of proceedings. These parties may include the postal administration (especially where the law requires mail for the debtor is to be delivered to the insolvency representative), tax authorities, social service authorities, and corporate regulators.

(iv) *Manner of giving notice*

145. In addition to the question of the time at which notice is to be given, an insolvency law may need to address, in order to ensure the effectiveness of the notice, the manner in which notice is given and the information to be included. The

manner of giving the notice could address both the party required to give the notice (e.g. the court or the party making the application for commencement) and how the information can be made available, with the key consideration being delivery or publication in a form that is generally likely to come to the notice of interested parties. For example, while individual notice may be provided directly to known creditors<sup>15</sup> (although in individual cases the effectiveness of this method will depend upon the state of the debtor's records), the need to inform unknown creditors has led legislators to adopt broad requirements such as publication in an official government publication or a commercial or widely circulated newspaper. That newspaper may be regional, national or local (by reference to the location of the debtor's business) depending upon the circumstances of the case and what will prove to be most cost effective. It may not always be necessary, for example, to require publication at considerable expense in a national newspaper when the debtor's business is based and conducted locally. To avoid the notification process becoming unwieldy and requiring in each case an investigation into what will prove to be the most effective means of giving notice, the obligation should refer to standard forms, with some flexibility for local conditions. Other options for achieving effective notification may include various forms of electronic communication and use of relevant public registries.

(v) *Content of the notice*

146. The information required in the notice may include the effect of the commencement of proceedings (especially as to the application of the stay—see chapter II); the time for submission of claims; the manner in which claims should be submitted and the place at which they should be submitted; the procedure and any form requirements necessary for submitting a claim; advice as to which creditors should make claims (i.e. whether secured creditors need to submit a claim—see chapter V.A); consequences of failure to make a claim or to make a claim in the prescribed manner; and information concerning verification of claims and meetings of creditors.

**6. Debtors with insufficient assets**

147. Many debtors that would satisfy the criteria for commencement of insolvency proceedings are never formally liquidated, either because creditors are reluctant to initiate proceedings where it appears that the debtor has no, or insufficient, assets to fund the administration of insolvency proceedings, or because debtors in such a position will rarely take steps to commence proceedings. Some insolvency laws provide that where an application for commencement is made in these circumstances, it will be denied on the bases of an assessment of insufficiency of assets by the court, while others provide a mechanism for appointment and remuneration of an insolvency representative (see chapter III.B.3). Some other laws provide for a surcharge on creditors to pay for the administration of estates (see Fees below).

148. There are a number of reasons, particularly of a public interest nature, for devising a mechanism to enable the administration of a debtor with apparently few

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<sup>15</sup> This will be facilitated by reference to the list of creditors to be provided by the debtor in cooperation with the insolvency representative see chapter IIIA.4(b) and III.B.4. See also art. 14, UNCITRAL Model Law on Cross-Border Insolvency.

or no assets under a formal proceeding. Where an insolvency law does not provide for exploratory investigations of insolvent companies with few or no assets, it does little to ensure the observance of fair commercial conduct or to further standards of good governance of commercial entities. Assets can be moved out of companies or into related companies prior to liquidation with no fear of investigation or the application of avoidance provisions or other civil or criminal provisions of the law. A mechanism for administration will assist in overcoming any perception that such abuse is tolerated, may provide a return for creditors where antecedent transactions can be avoided, as well as a means of investigating the conduct of the management of such debtors and may encourage entrepreneurial activity and responsible economic risk-taking through a discharge and fresh start for entrepreneurs and others engaging in commercial activities—the punitive and deterrent aspects of insolvency laws will be less appropriate where the debtor is honest.

149. Mechanisms for pursuing the administration of such estates may include, as noted above, levying a surcharge on creditors to fund administration; establishing a public office or utilising an existing office to administer insolvent debtors; establishing a fund out of which the costs may be met; appointing a listed insolvency professional on the basis of a roster or rotation system, which is designed to ensure a fair and ordered distribution of all insolvency cases, whether with insufficient assets or otherwise, where the insolvency representative will be paid a prescribed stipend by the State or the costs will be borne directly by the insolvency representative and cross-subsidised by their clients generally (since, where they are a professional, their remunerative rates can be adjusted to take into account unremunerative work—this approach could not be taken where the insolvency representative is a government official). Where such a mechanism is included in an insolvency law, consideration may also need to be given to defining those debtors to which the provisions will apply, such as by reference to a debtor having available less than a prescribed value of unencumbered assets and no regular source of revenue that would otherwise enable the liquidation to proceed.

## **7. Fees for insolvency proceedings**

150. Cost effectiveness, in addition to speed and efficiency, is an important aspect of an effective insolvency regime and one that bears upon all phases of the insolvency process. It is thus important, when designing an insolvency regime, to avoid the situation where the procedure is subject to cost burdens that will deter creditors, discourage commencement and frustrate the basic objectives of the procedure. This is of particular importance in the case of insolvency of small and medium-size businesses. It may also be particularly important where, for example, the debtor has a large debt which comprises a number of smaller creditors whose individual debts might not support the costs of the application procedure, or where the estate has few assets.

151. Applications by both debtors and creditors for commencement of insolvency proceedings may be subject to the payment of fees. Different approaches may be taken to the level of fee imposed. One approach might be to set a fee that can be used to help defray the costs of the insolvency system. Where the resultant fee is high, however, it could operate as a deterrent and run counter to the objective of convenient, cost effective and quick access to the insolvency process. A very low fee, on the other hand, might not be sufficient to deter frivolous applications and it

is therefore desirable that a balance between these objectives be reached. Some insolvency laws require the creditors making an application to guarantee the payment of the costs of the proceedings up to a certain fixed amount, to pay a certain percentage of the total of claims or a fixed amount as a guarantee for costs. In some laws where a payment as security for costs is required, that amount may be refunded from the estate if there are sufficient assets, and certain creditors, such as employees, are exempted from providing the required security. Other laws require, as a condition of commencement, that the unencumbered assets of the estate must be sufficient to cover the costs of the proceedings. Where they are insufficient, the insolvency law generally provides for the application to be denied or for it to be treated in accordance with provisions on estates with few or no assets (see above). A further approach establishes the fees that may be levied as a fixed percentage of the value of the assets of the estate. In large cases, this may result in significant fees being paid out of the estate, discouraging both creditor and debtor applications.

#### **8. Dismissal of proceedings after commencement**

152. In addition to circumstances where the application to commence proceedings might be denied as discussed above (chapter II.B.5(d)), there will also be instances where, after proceedings have already commenced, an insolvency law should permit them to be dismissed. A dismissal procedure will be relevant irrespective of whether an application by the debtor functions to automatically commence proceedings and no opportunity exists for the application to be challenged by creditors and other interested parties at the time of commencement, or the decision to commence is made by the court. The grounds for dismissal would be essentially the same as those for denial, that is, that there is improper use of the insolvency law, either by the debtor or creditors, or that the debtor did not satisfy the commencement criteria at the time of commencement.

### **Recommendations**

#### **Purpose of legislative provisions**

The purpose of provisions on commencement of insolvency proceedings is to:

- (a) facilitate access for debtors and creditors to the remedies provided by the law;
- (b) establish commencement criteria that are transparent and certain;
- (c) enable applications for insolvency proceedings to be made and dealt with in a speedy, efficient and cost effective manner;
- (d) establish safeguards to protect both debtors and creditors from improper use of the application procedure;
- (e) establish requirements for effective notification of commencement of proceedings.

#### **Contents of legislative provisions**

- (7) The law should include provisions addressing both reorganization and liquidation of a debtor.

**Commencement standard***- Persons permitted to apply*

(8) The law should specify the parties permitted to make an application for commencement of insolvency proceedings which should include the debtor and any of its creditors.<sup>16</sup>

*- Debtor application*

(9) The law should specify that insolvency proceedings can be commenced on the application of a debtor if the debtor can show either that:

- (a) it is or will be generally unable to pay its debts as they mature; or
- (b) its liabilities exceed the value of its assets.<sup>17</sup>

*- Creditor applications*

(10) The law should specify that insolvency proceedings can be commenced on the application of a creditor if it can be shown that either:

- (a) the debtor is generally unable to pay its debts as they mature; or
- (b) the debtor's liabilities exceed the value of its assets.

*Presumption that the debtor is unable to pay*

(11) The law may establish a presumption that, if the debtor fails to pay one or more of its mature debts, and the whole of the debt is not subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt claimed, the debtor is generally unable to pay its debts.<sup>18</sup>

*Commencement on debtor application*

(12) The law should specify that where the application for commencement is made by the debtor:

- (a) the application for commencement will automatically commence the insolvency proceedings; or

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<sup>16</sup> This would include a government authority that is a creditor of the debtor.

<sup>17</sup> The intention of this recommendation and the recommendation on creditor applications is to allow legislators flexibility in developing commencement standards, based on a single or dual test approach. Where the law adopts a single test, it should be based on the debtor's inability to pay debts as they mature (cessation of payments test) and not on the balance sheet test. Where the law contains both tests (cessation of payments and balance sheet tests) proceedings can be commenced if one of the tests can be satisfied.

<sup>18</sup> Where the debtor has not paid a mature debt and the creditor has obtained a judgement against the debtor in respect of that debt, there would be no need for a presumption to establish that the debtor was unable to pay its debts. The debtor could rebut the presumption by showing, for example, that it was able to pay its debts; that the debt was subject to a legitimate dispute; or that the debt was not mature. The recommendations on notice of commencement provide protection for the debtor by requiring notice of the application for commencement of proceedings to be given to the debtor and providing the debtor with an opportunity to rebut the presumption.

(b) the court will promptly determine its jurisdiction and whether the debtor is eligible and the commencement standard has been met and if so, commence insolvency proceedings.

*Commencement on creditor application*

(13) Where the application for commencement is made by a creditor the law generally should specify that:

- (a) notice of the application promptly be given to the debtor;<sup>19</sup>
- (b) the debtor be given the opportunity to respond to the application; and
- (c) the court promptly determine its jurisdiction and whether the debtor is eligible and the commencement standard has been met and if so, commence insolvency proceedings.<sup>20</sup>

*Denial of an application to commence proceedings*

(14) The law should specify that, where the decision to commence proceedings is to be made by the court, the court may deny the application to commence and, where appropriate, impose costs or sanctions against the applicant, if it determines:

- (a) that it does not have jurisdiction, the debtor is ineligible or does not meet the commencement standard; or
- (b) that the application is an improper use of the law.

(15) Where the application was made by a creditor, the law should specify that the debtor promptly be given notice of the decision to deny.

*Notice of commencement of proceedings*

(16) The law should establish procedures for giving notice of the commencement of insolvency proceedings.

*- General notice*

(17) The law should specify that the means of giving notice of the commencement of insolvency proceedings must be appropriate<sup>21</sup> to ensure that the information is likely to come to the attention of interested parties.<sup>22</sup> The law should specify the party responsible for giving that notice.

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<sup>19</sup> Where the debtor's whereabouts is unknown and it cannot be contacted, the general law may provide relevant rules concerning the giving of notice in such circumstances.

<sup>20</sup> A determination that the commencement standard has been met may involve consideration of whether the debt is subject to a legitimate dispute or offset in an amount equal to or greater than the amount of the debt (see also chapter II.B.5 (d)).

<sup>21</sup> The question of what is appropriate in a particular case will also involve considerations of cost effectiveness and the insolvency law should not require, for example, expensive publication in a national newspaper, when publication in a local paper will suffice.

<sup>22</sup> General notice would generally be provided by way of making the information available in a publication such as an official government gazette, a widely circulated national, regional or local newspaper, through electronic means, or through relevant public registries.

- *Notice to creditors*

(18) The law should specify that notice of the commencement of proceedings is to be given to creditors individually, unless the court considers that, under the circumstances, some other form of notice would be more appropriate.<sup>23</sup>

- *Content of notice*

(19) The law should specify that the notice of commencement of insolvency proceedings include:

- (a) information concerning submission of claims, including the time and place for submission;
- (b) the procedure and form requirements for the submission of claims;
- (c) the consequences of failure to submit a claim in accordance with paragraphs (a) and (b); and
- (d) information concerning verification of claims, application of the stay and its effects, and meetings of creditors.

*Debtor with insufficient assets*

(20) The law should specify the treatment of debtors whose assets and sources of revenue are insufficient to meet the costs of administering the insolvency proceedings. Different approaches may be taken including:

- (a) denial of the application, except where the debtor is an individual who would be entitled to a discharge; or
- (b) commencement of the proceedings, where different mechanisms for appointment and remuneration of the insolvency representative may be available.<sup>24</sup>

*Dismissal of insolvency proceedings*

(21) The law should permit the court to dismiss proceedings if, after commencement, the court determines, for example, that:

- (a) the proceedings constitute an improper use of the insolvency law; or
- (b) the debtor was ineligible or did not meet the commencement standard at the time of commencement.

(22) The law should specify that where proceedings are dismissed, the court may impose costs or sanctions, where appropriate, against the applicant for commencement of the proceedings.

(23) The law should require notice of a decision to dismiss proceedings to be given.

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<sup>23</sup> The obligation to prepare the list of creditors to be given notice is dealt with under obligations of the insolvency representative and the debtor (see chapter III).

<sup>24</sup> See chapter III.B.



## **II. Treatment of assets on commencement of insolvency proceedings**

### **A. Assets constituting the insolvency estate**

#### **1. Introduction**

153. Fundamental to insolvency proceedings is the need to identify, collect, preserve and dispose of assets that belong to the debtor. Many insolvency systems place these assets under a special regime sometimes referred to as the insolvency estate, over which the insolvency representative will have specified powers, subject to certain exceptions.

154. This Guide uses the term “estate” in its functional sense to refer to assets of the debtor that are controlled by the insolvency representative and are subject to the insolvency proceedings. There are some important differences in the way in which the concept of the insolvency estate is understood in various jurisdictions. In some countries, the insolvency law provides that legal title over the assets is transferred to the designated official (generally the insolvency representative). In other countries, the debtor continues to be the legal owner of the assets, but its powers to administer and dispose of those assets are limited, because the insolvency representative will have complete control of the assets or because the debtor will only be able to deal with assets in the ordinary course of business, and use or disposal of assets outside of the ordinary course of business, including by the creation of security interests, will require the consent of the insolvency representative or, in some cases, the court.

155. Irrespective of the applicable legal tradition, an insolvency law will need to clearly identify the assets that will be subject to the insolvency proceedings and therefore included within the concept of the estate and indicate how they will be affected by those proceedings, including clarifying the relative powers of the various participants. Identification of assets and their treatment will determine the scope and conduct of the proceedings and, particularly in reorganization, will have a significant bearing on the likely success of those proceedings. The inclusion in an insolvency law of clear and comprehensive provisions on these issues will ensure transparency and predictability for both creditors and the debtor.

#### **2. Assets included in the insolvency estate**

##### **(a) General definition of the insolvency estate**

156. The estate may be expected to include all assets of the debtor including rights and interests in property wherever located, whether or not in the possession of the debtor at the time of commencement, and including all tangible (whether movable or immovable) and intangible assets. It would also include the debtor’s rights and interests in assets subject to a security interest and in third party owned assets (where the continued use of those assets by the estate may be subject to other provisions of the insolvency law (see chapter II.C)). Generally, assets acquired by either the debtor or the insolvency representative after commencement of the insolvency proceedings (subject to specific exclusions that would apply in the case of natural person debtors (see below)) and assets recovered through avoidance or other actions would also be included. Some of these assets may be freely sold or exchanged while others may be subject to limitations that arise from contract or

other law (e.g. a non-assignable government licence or a customer list that is subject to privacy restrictions) or involve mediating problems that can arise with respect to other rights in those assets. Notwithstanding such limitations, it is desirable that these assets be included in the estate.

157. Tangible assets should be readily found on the debtor's balance sheets, such as cash, equipment, inventory, works in progress, bank accounts, accounts receivable and real estate. The assets to be included within the category of intangible assets may be defined differently in different States, depending upon the national law, but may include intellectual property, securities and financial instruments, policies of insurance, contract rights (including those relating to assets owned by third parties), and rights of action arising from a tort<sup>25</sup> to the extent of the debtor's interest. The inclusion of some intangible assets in the estate may give rise to conflicts with other laws, such as laws restricting transferability or laws relating to privacy protection. In the case of natural persons, the estate may also include assets such as inheritance rights in which the debtor has an interest or to which the debtor is entitled at the commencement of the insolvency or which come into existence during the insolvency proceedings, as well as the debtor's interest in assets owned jointly by the debtor and another person, including the debtor's spouse.

158. Notwithstanding the desirability of a broad definition of the estate, the inclusion of a number of types of assets can be controversial. Some assets can be included in the estate without difficulty, such as assets belonging to the debtor and that are unencumbered, assets that are not disputed by a third party, and assets recovered by the insolvency representative, whether through claims against a third party or through avoidance actions. Other assets can be excluded from the estate without difficulty, such as assets belonging to a third party in which the debtor has no interest and assets belonging, with full ownership rights, to the debtor's spouse. Assets such as encumbered assets, joint assets, assets located abroad, some intangible assets and third party owned assets in which the debtor has an interest can raise difficult questions. These are discussed in the following sections.

**(b) Encumbered assets**

159. One question of some importance is whether the insolvency law includes encumbered assets as part of the insolvency estate. Insolvency laws adopt different approaches to the treatment of assets subject to security interests. Many laws provide that encumbered assets are included in the insolvency estate, with the commencement of proceedings giving rise to different effects, such as limiting the exercise of security rights held by creditors or third parties by application of a stay and other effects of commencement. Including encumbered assets in the estate and thus limiting the exercise of rights by secured creditors may assist not only in ensuring equal treatment of creditors, but may be crucial to the proceedings where the encumbered asset is essential to the business. For example, where manufacturing equipment or a leased factory building is central to the debtor's business operations, reorganization or sale of the business as a going concern cannot take place unless

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<sup>25</sup> Where the debtor is a natural person, some jurisdictions exclude torts of a personal nature such as defamation, injury to credit or reputation or personal bodily injury, where the debtor remains personally entitled to sue and to retain what is recovered on the basis that the incentive to vindicate wrongdoing otherwise would be diminished, but may not be entitled to sue for any loss of earnings associated with those causes of action.

the equipment and the lease can be retained for the proceedings. There will be advantages particularly in reorganization and where the business is to be sold as a going concern in liquidation, in having all assets of the debtor available to the insolvency estate from the time of commencement.

160. Where the encumbered assets are included in the insolvency estate, they may also be subject to certain protections such as those relating to maintaining the value of the encumbered asset or the secured portion of a creditor's claim and to specified situations where the encumbered asset may be separated from the estate (see for example chapter II.C). An insolvency law should make it clear that such an inclusion will not deprive secured creditors of their property rights in the encumbered assets, even if it does operate to limit the exercise of those rights (for example, postponement by operation of the stay).

161. Other insolvency laws provide that the security right is unaffected by insolvency proceedings and secured creditors may proceed to enforce their legal and contractual rights. Recognizing that there will be cases where encumbered assets may be crucial to the proceedings, there are examples of laws which provide that even where those assets are unaffected by the insolvency, the debtor, with the insolvency representative's consent, can ask the court to prevent enforcement where the asset is necessary for the business to continue operating. Exclusion of encumbered assets may have the advantage of generally enhancing the availability of credit because secured creditors would be reassured that their interests would not be adversely affected by the commencement of insolvency proceedings. It is increasingly recognized, however, that this general advantage to an economy is outweighed by the advantages to be derived from including encumbered assets in the insolvency estate and restricting the exercise of secured creditors' rights as noted above.

**(c) Third party owned assets**

162. Some jurisdictions permit assets in which a creditor retains legal title or ownership (for example, a retention of title or a lease arrangement) to be separated from the insolvency estate on the basis that the insolvency law should respect the creditor's legal title in the asset. In some jurisdictions the separation of the asset may be subject to the provisions of the insolvency law relating to treatment of contracts. The estate will generally include, however, as indicated above in the general definition of the estate, any rights that the debtor might have in respect of those third party owned assets. There will be cases where the third party owned assets, may be crucial, like encumbered assets, to the continued operation of the business, whether in reorganization or sale as a going concern in liquidation. In those cases, it will be advantageous for the insolvency law to include a mechanism which will permit third-party owned assets to remain at the disposal of the insolvency proceedings, subject to protecting the interests of the third party owner and to the right of the third party to dispute that inclusion. These issues are discussed further in chapter II.C.

163. If the economic terms of the transaction demonstrate that it is a device to finance the acquisition of an asset, although structured, for example, as a lease, some laws treat the arrangement as a secured lending arrangement and in insolvency the lessor will be subjected to the same treatment as other secured creditors. A transaction will be a financing device where, at the end of the term of the lease, either the debtor can retain the asset for the payment of a nominal sum or the

remaining value of the asset is negligible. The insolvency law may regard the debtor's rights as part of the insolvency estate and permit the asset to be used by the insolvency representative subject to certain conditions as described in chapter II.C.

164. Where the interest in assets that is claimed by the debtor is disputed by a third party, it will be desirable for the insolvency law to enable those assets to be protected on an interim basis to ensure their preservation pending decision by the court as to ownership. Where the decision is that the assets do not form part of the estate, the law may also address issues of damage to the third party arising from the debtor's retention. The issue of damages may also be relevant where a third party withholds assets that are found to form part of the estate.

**(d) Foreign assets**

165. Whether the debtor's assets outside the country where the proceedings are taking place will become part of the estate raises issues of cross-border insolvency. This may be of particular importance in reorganization, where the exclusion of foreign assets could significantly affect the success of the proceedings. Some insolvency laws take the approach that there should be a single insolvency proceeding, based in the country where the debtor has its head office or place of registration or incorporation (centre of main interests), that will apply to the debtor's assets wherever situated (the universal approach). This approach includes the idea that the State adopting it will accept the same claim made under the insolvency law of another State. Other insolvency laws are based upon an approach that limits the applicability of the insolvency law to the geographical area governed by the jurisdiction enacting the legislation (the territorial approach). This approach requires different proceedings to be commenced in each jurisdiction in which the debtor has assets or in which different branches or establishments of the debtor are located. Another approach is a modified version where a State claims universal application of its own law, but does not recognize the same universal application of the laws of other States.

166. The existing diversity of approaches to this issue creates considerable uncertainty and undermines the effective application of national insolvency laws. However, as the differences between insolvency laws increasingly narrow and greater convergence emerges, there are fewer reasons for maintaining the territorial approach. It is increasingly desirable that an insolvency law provides for the insolvency estate to comprise all assets of the debtor wherever located. However, since divergence is likely to remain for some time, the UNCITRAL Model Law on Cross-Border Insolvency establishes a regime for effective cooperation in cross-border insolvency cases through recognition of foreign decisions and access for foreign insolvency representatives to local court proceedings. The regime is intended to be compatible with all legal systems and is discussed in more detail in chapter VII.

**(e) Recovered assets**

*(i) Avoidance proceedings*

167. Assets that will be subject to the proceedings will include any assets or their value recovered by the insolvency representative through avoidance proceedings where the transaction resulted in preferential treatment to some creditors or were

prejudicial to the insolvency estate or made in an effort to defeat the collective rights of creditors (see chapter II.F).

(ii) *Unauthorized post-application and post-commencement transactions*

168. Many insolvency laws adopt measures intended to limit the extent to which a debtor subject to insolvency proceedings can deal with its assets, whether encumbered or not, without the authorization of the court or the insolvency representative (see chapter II.B.8(b) and 9). These restrictions generally will apply after the commencement of insolvency proceedings, but may also apply after an application for commencement of proceedings in those cases where the powers to deal with assets of the estate are given to an interim insolvency representative. Some insolvency laws treat transactions which are not authorized as invalid and unenforceable as against the insolvency estate, and enable any assets transferred to be reclaimed, except in some cases where the counterparty gave value or can prove that the transaction did not impair creditors' rights. Other insolvency laws achieve the same result by addressing unauthorized contracts in terms of avoidance provisions, depending upon how the suspect period is calculated (see chapter II.F.3).

**3. Assets excluded from the insolvency estate**

**(a) General exclusions**

169. The insolvency law may specify the exclusion of certain assets from the estate. Insolvency laws adopt different approaches to this issue. Assets excluded from the estate may include, for example, certain assets owned by a third party that are in the possession of the debtor when the proceedings commence, such as trust assets and assets subject to an arrangement (whether contractual or otherwise) that does not involve a transfer of title but rather use of the assets and return to the owner once the purpose for which they were in the possession of the debtor has been fulfilled.<sup>26</sup> Assets excluded from the estate may also include assets subject, under some laws, to reclamation, such as goods supplied to the debtor before commencement, but not paid for and recoverable by the supplier (subject to identification and other applicable conditions).

**(b) Where the debtor is a natural person**

170. In the case of insolvency of a natural person, the insolvency law may provide that the estate should exclude certain assets such as post-application earnings from the provision of personal services by the debtor, assets that are necessary for the debtor to earn a living and personal and household assets, such as furniture, household equipment, bedding, clothing and other assets necessary to satisfy the basic domestic needs of the debtor and its family. Such exclusions generally would not be available to legal person debtors. Where an insolvency law provides exclusions in respect of the assets of a natural person, they should be clearly identified and their number and value limited to the minimum necessary to preserve the personal rights of the debtor and allow the debtor to lead a productive life. In identifying these exclusions, consideration might need to be given to applicable human rights obligations, including international obligations, which are intended to protect the debtor and relevant family members and may affect the exclusions that

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<sup>26</sup> Such an arrangement may be known as a bailment or depositum.

should be made.<sup>27</sup> A further consideration may be the economic effects of exclusions; some research suggests that the full or substantial exemption of personal assets from insolvency proceedings may have a positive effect on entrepreneurship and risk-taking.

#### *Joint assets*

171. Where the debtor is a natural person and personal assets are owned jointly by the debtor and the debtor's spouse, different approaches to the treatment of these assets are adopted, whether by the insolvency law or other law, such as that relating to matrimonial property or property ownership. In some federal jurisdictions this issue may involve questions of both state and federal law. The relationship between those other laws and the insolvency law may determine how certain provisions of the insolvency law, for example, avoidance provisions, will apply.

172. One approach to the treatment of joint assets is to completely exclude those assets from the estate. Another approach provides that where the proceedings are opened against the assets of one spouse, the part of the mutual assets belonging to that spouse can become part of the insolvency estate if, under the general law other than the insolvency law, the assets can be divided for purposes of execution (where division of the assets will be conducted outside of the insolvency law and proceedings). The choice between these approaches therefore may depend upon the operation of law other than the insolvency law and factors such as the ease with which the assets may be divided (see chapter II.C.2).

#### **4. Time of constitution of the insolvency estate and collection of assets**

173. The insolvency law should specify the date by reference to which assets will be considered to be part of the estate to provide certainty for the debtor and for creditors. Some insolvency laws refer to the date of commencement of proceedings, while others refer to the date of the application for commencement or to an act of insolvency that forms the basis of the application. The significance of the difference between these dates relates to the treatment (and most importantly the protection) of the debtor's assets in the interim period between application and commencement. For that reason, some laws constitute the estate from the date of application. Other laws, for reasons of clarity and certainty, constitute the estate from the date of commencement, but also contain provisions that restrict the debtor's powers to dispose of property during the period following the making of the application. Assets disposed of in that period can be reclaimed by the insolvency representative. A further consideration with respect to protection of assets between application and commencement is the application of avoidance provisions and the date from which the suspect period is calculated (see chapter II.F.6).

174. Whichever date is chosen, the estate may be expected to include the assets of the debtor as at that date as well as assets acquired by the insolvency representative and the debtor after that date, whether in the exercise of avoidance powers (see chapter II.F) or in the normal course of operating the debtor's business.

175. Once the assets to be included in the estate are identified, they must be collected. To achieve this, the insolvency law may include powers enabling the

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<sup>27</sup> In Europe, for example, the European Convention on Human Rights 1950 is relevant.

insolvency representative to establish control over assets determined to part of the estate, as well as obligations to ensure that the debtor and other relevant parties assist and cooperate with the insolvency representative in that regard. Where assets are located in a foreign country, additional measures will be required, such as those set forth in the UNCITRAL Model Law on Cross-Border Insolvency.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions relating to the insolvency estate is to:

(a) identify those assets that will be included in the estate formed on commencement of proceedings, including the debtor's interests in assets subject to a security interest and in third party-owned assets;

(b) identify the assets, if any, that will be excluded from the estate.

### Contents of legislative provisions

#### *Assets constituting the estate*

(24) The law should identify the assets that will constitute the estate, including:

(a) assets of the debtor [owned<sup>28</sup> by the debtor] including the debtor's interest in assets subject to a security interest and in third party-owned assets as at [the time of application for commencement] [commencement] of insolvency proceedings;

(b) assets acquired after commencement of the insolvency proceedings; and

(c) assets recovered through avoidance and other actions.

(25) In the case of insolvency proceedings commenced where the debtor has its centre of main interests, the law should specify that the estate includes all assets of the debtor wherever located.<sup>29</sup>

#### *Assets excluded from the estate where the debtor is a natural person*<sup>30</sup>

(26) The law should specify the assets, if any, that are excluded from the estate where the debtor is a natural person.

## B. Protection and preservation of the insolvency estate

### 1. Introduction

176. An essential objective of an effective insolvency system is the establishment of a protective mechanism to ensure that the value of the insolvency estate is not diminished by the actions of the various parties and allow the insolvency

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<sup>28</sup> Ownership would be determined by reference to the relevant applicable law.

<sup>29</sup> Where the law adopts a universal approach as recommended here, the law should also address the issue of recognition of foreign proceedings, see UNCITRAL Model Law on Cross-Border Insolvency (chapter VII).

<sup>30</sup> Exclusions generally are not provided for legal person debtors. On assets that may be excluded in respect of natural persons see chapter II.3(b).

proceedings to be administered in a fair and orderly manner. The parties from whom the estate needs the greatest protection are the debtor and its creditors.

## 2. Protection of the estate by application of a stay

177. With regard to creditors, one of the fundamental principles of insolvency law is that insolvency proceedings are collective proceedings, which require the interests of all creditors to be protected against individual action by one of them. Many insolvency laws provide for the imposition of a mechanism that not only prevents creditors from enforcing their rights through legal remedies during some or all of the period of the liquidation or reorganization proceedings, but also suspends actions already underway against the debtor and prevents the commencement of new actions. This mechanism is variously termed a moratorium, suspension or stay, depending on the effect of the mechanism. For the purposes of this Guide, the term “stay” is used in a broad sense to refer to both suspension of actions and a moratorium on the commencement of actions.

### (i) *Liquidation*

178. As a general principle, the emphasis in liquidation is on selling the assets, in whole or in part, so that creditors claims can be satisfied from the proceeds of realization of the estate as quickly as possible. Maximizing value is an overriding objective. The imposition of a stay can ensure a fair and orderly administration of the liquidation proceedings, providing the insolvency representative with adequate time to avoid making forced sales that fail to maximize the value of the assets being liquidated, and also an opportunity to see if the business can be sold as a going concern, where the collective value of assets may be greater than if the assets were to be sold piecemeal. A stay also allows the insolvency representative to take stock of the debtor’s situation, including actions already pending, and provides time for all actions to be fully considered, increasing the possibility of achieving a result that is not prejudicial to the interests of the debtor and creditors. The balance that is difficult to achieve in liquidation proceedings is between the competing interests of secured creditors, who will often hold security in some of the most important assets of the business, and unsecured creditors.

### (ii) *Reorganization*

179. In reorganization proceedings, the application of a stay facilitates the continued operation of the business and allows the debtor a breathing space to organize its affairs, time for preparation and approval of a reorganization plan and for other steps such as shedding unprofitable activities and onerous contracts, where appropriate. As in liquidation, it also provides an opportunity to consider actions pending against the debtor. Given the goals of reorganization, the impact of the stay is greater and therefore more crucial than in liquidation and can provide an important incentive to encourage debtors to initiate reorganization proceedings. At the same time, the commencement of proceedings and the imposition of the stay give notice to all those who do business with the debtor that the future of the business is uncertain. This can cause a crisis of confidence and uncertainty as to how the insolvency proceedings will impact upon suppliers, customers and employees of the debtor’s business.



180. The immediate benefits that accrue to the debtor by having a broad stay quickly imposed to limit the actions of creditors will need to be balanced against the longer-term benefits that are derived from limiting the degree to which the stay interferes with contractual relations between debtors and creditors, especially secured creditors.

### **3. Scope of application of the stay**

#### **(a) Actions to which the stay will apply**

181. Some countries adopt the approach that to ensure the effectiveness of the stay, it must be very wide, applying to all remedies and proceedings against the debtor and its assets, whether administrative, judicial or self-help and restraining both unsecured and secured creditors from enforcing their rights, as well as governments from exercising priority rights. Examples of the types of actions and acts that may be stayed could include the commencement or continuation of actions or proceedings against the debtor or in relation to its assets; the commencement or continuation of enforcement proceedings in relation to assets of the debtor, including the execution of a judgement and perfection or enforcement of a security interest; recovery by any owner or lessor of property that is used or occupied by, or is in the possession of, the debtor; payment or provision of security in respect of a debt incurred by the debtor prior to the commencement date; the right of the debtor to transfer, encumber or otherwise dispose of any assets (in reorganization, this might be limited to transfer, encumbrance or disposal outside the ordinary course of business); the right of a counterparty to terminate a contract with the debtor (except where the contract provides a termination date that happens to fall after commencement);<sup>31</sup> and termination, suspension or interruption of supplies of essential services (for example, water, gas, electricity and telephone) to the debtor. Article 20 of the UNCITRAL Model Law on Cross-Border Insolvency (see chapter VII), for example, provides that commencement or continuation of individual actions or individual proceedings concerning the debtor's assets, rights, obligations or liabilities and execution against the debtor's assets are stayed. The types of individual actions referred to above should cover those commenced both in the courts and before an arbitral tribunal.<sup>32</sup>

182. One of the reasons for including continuation of proceedings within the scope of the stay is that the need for the insolvency representative to become involved in ongoing cases (where the debtor is divested of control) can distract and divert resources away from its task of administering the estate. A default judgement, for example, could be entered against the debtor and form the basis of a creditor's claim in the proceedings when, on a proper adjudication, the action might have been dismissed or judgement entered for a smaller amount. Since most insolvency laws include a mechanism to process claims—addressing submission, verification, and approval—and to make distributions, most proceedings with respect to those claims being conducted outside of the insolvency case are rendered superfluous. Nevertheless, some insolvency laws provide that, where legal proceedings against

<sup>31</sup> To give the insolvency representative time to assess the contract's importance to the proceedings and what action should be taken with respect to continuation or rejection. See chapter II.E.

<sup>32</sup> It may not always be possible, however, to implement an automatic stay of arbitral proceedings, such as where the arbitration takes place in a foreign State rather than in the State in which insolvency proceedings are commenced.

the debtor (including both commencement and continuation of those proceedings) are within the scope of the stay, those proceedings can be commenced or continued at the discretion of the court if it is considered necessary to preserve a claim or establish the quantum of a claim.<sup>33</sup>

183. Other insolvency laws allow the commencement or continuation of legal proceedings (without leave of the court), but the application of the stay prevents enforcement of any resulting order. Some insolvency laws limit the actions that may be pursued and only specific actions, such as employee actions against the debtor, can be commenced or continued, but any enforcement action resulting from those proceedings will be stayed. In some insolvency laws a distinction is made between regulatory and pecuniary actions. Some laws allow claims of both a regulatory and pecuniary nature to be continued, others only regulatory claims, such as those that are not designed to collect money for the estate but to protect vital and urgent public interests, restraining activities causing environmental damage or activities that are detrimental to public health and safety.

**(b) Exclusions from application of the stay**

184. To ensure transparency and predictability, it is highly desirable that an insolvency law clearly identify the actions that are to be included within and specifically excluded from the scope of the stay, irrespective of who may commence those actions, whether unsecured creditors (including preferential creditors such as employees, legislative lienholders or governments), third parties (such as a lessor or owner of property in the possession or use of the debtor or occupied by the debtor), secured creditors or others. Exclusions might include: set-off rights and netting of financial contracts (see chapter II.G); actions to protect public policy interests, such as to restrain environmental damage or activities detrimental to public health and safety; actions to prevent abuse, such as the use of insolvency proceedings as a shield for illegal activities; actions commenced in order to preserve a claim against the debtor; and actions against the debtor for personal injury or family law claims.<sup>34</sup> With respect to claims against the debtor that have the potential for very large compensation awards, such as mass tort claims, it is desirable that they be included within the scope of the stay.

**(c) Secured creditors**

185. The scope of rights that are affected by the stay varies considerably among insolvency laws. There is little debate regarding the need for the stay to apply to suspend or prevent the commencement of actions by unsecured creditors against the debtor or its assets. The application of the stay to secured creditors, however, is potentially more difficult and requires a number of competing interests to be balanced. These include, for example, respecting the pre-insolvency priorities of secured creditors as regards their rights over the encumbered assets; minimizing the

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<sup>33</sup> Article 20(3) of the UNCITRAL Model Law on Cross-Border Insolvency, for example, provides that the application of the stay to commencement or continuation of individual actions or proceedings against the debtor is not to affect the right to commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor.

<sup>34</sup> Some jurisdictions, for example, will exclude from the application of the stay the performance of obligations of the debtor that do not affect the estate, e.g. to give parental access in a family law situation.

effect of the stay on the value of encumbered assets; and, in cases of reorganization, ensuring that all assets necessary for the successful reorganization of a viable debtor are available to the proceedings.

186. Creditors generally seek security for the purpose of protecting their interests in the event that the debtor fails to repay. If security is to achieve this objective, it can be argued that, upon commencement of insolvency proceedings, the secured creditor should not be delayed or prevented from immediately enforcing its rights against the encumbered asset. The secured creditor has, after all, bargained for security in exchange for value that reflects the reliance on the security interest. For that reason, the introduction of any measure that will diminish the certainty of the secured creditor's ability to recover debt or erode the value of security interests, such as applying the stay to secured creditors, may need to be carefully considered. Such a measure may ultimately undermine not only the autonomy of the parties in their commercial dealings and the importance of observing commercial bargains, but also the availability of affordable credit; as the protection provided by security interests declines, the price of credit may need to increase to offset the greater risk. Some of the insolvency laws that exclude secured creditors from the stay focus, as an alternative to the stay, on encouraging pre-commencement negotiations between the debtor and creditors to achieve agreement on how to proceed.

(i) *Reorganization*

187. A growing number of insolvency laws recognize, however, that in many cases permitting secured creditors to freely enforce their rights against the encumbered asset can frustrate the basic objectives of the insolvency proceedings, particularly in reorganization, and for that reason they are included within the scope of the stay, subject to certain protections. It may be worth noting that the increasing acceptance by banks and other financial institutions of moratoriums in voluntary restructuring negotiations conducted pursuant to such rules as the "London Approach" (see part one, chapter II) may be responsible in part for the growing acceptance by secured creditors of the application of the stay to them in proceedings under the insolvency law.

188. Insolvency laws take different approaches to the application of the stay to secured creditors in liquidation proceedings. As a general principle, where the insolvency representative's function is to collect and realize assets and distribute proceeds among creditors by way of dividend, the secured creditor may be permitted to freely enforce its rights against the encumbered asset to satisfy its claim without affecting the liquidation of other assets. Some insolvency laws thus exclude secured creditors from the scope of the stay on the basis that where the assets are to be liquidated the balance will weigh in favour of allowing secured creditors to enforce their rights. Where that approach is adopted, however, some flexibility may be needed in cases where the insolvency representative may be able to achieve a better result that maximizes the value of the assets for the collective benefit of all creditors if the stay is applied to secured creditors. This may be particularly relevant where the business can be sold as a going concern in the context of the liquidation proceeding. It may also be true in some cases where even though assets are to be sold in a piecemeal manner, some time is needed to arrange a sale that will give the highest return for the benefit of all unsecured creditors.

189. Where secured creditors are included within the scope of the stay, an insolvency law can adopt measures that will ensure the interests of the secured creditor are not diminished by the stay. These measures may relate to the duration of the stay, protection of the value of the encumbered assets, payment of interest and provision of relief from the stay where the encumbered assets are not sufficiently protected or where they are not necessary to the sale of the entire business or a productive part of it.<sup>35</sup>

#### **4. Discretionary or automatic application of the stay**

190. A preliminary question on application of the stay is whether it should apply automatically (by operation of the insolvency law) or at the discretion of the court. Local policy concerns and factors such as the availability of reliable financial information and the ability of the debtor and creditors to access an independent judiciary with insolvency experience may affect the decision on this issue. Application of the stay on a discretionary basis may allow the stay to be tailored to the needs of the specific case (as regards the debtor, its assets and its creditors and the time of application of the stay) and avoid both unnecessary applications of the stay and unnecessary interference with the rights of secured creditors. This approach, however, has the potential to cause delay while the court considers the relevant issues; does not create a predictable situation for those creditors and third parties to whom the stay ultimately may apply; and may create a need for some mechanism, such as provisional measures, to address the period before the court decides on the application of the stay, as well as requiring the giving of notice as to application of the stay. An alternative approach which minimizes delay, will assist the achievement of the maximization of the value of the assets and ensure that the insolvency process is fair and ordered as well as transparent and predictable, might be to provide for the stay to apply automatically to specified actions (either on application or commencement of proceedings), with the possibility of extension of the stay to other actions at the discretion of the court. This approach is adopted in the UNCITRAL Model Law on Cross-Border Insolvency: article 20 specifies the types of actions that will be stayed automatically upon recognition of foreign main proceedings, while article 21 indicates examples of additional relief that may be ordered upon recognition, at the discretion of the court. The automatic stay is a feature of many modern insolvency law regimes and can be combined with provisions permitting relief in specified circumstances.

#### **5. Time of application of the stay**

191. A further concern related to application of the stay is the time at which it will apply in both liquidation and reorganization proceedings. There are essentially two approaches. Under the first, the stay applies from the time of the making of an application for commencement of proceedings and under the second, from the time of the commencement of proceedings, with provisional measures being available to cover the period between application and commencement.

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<sup>35</sup>Where a secured transactions regime provides a grace period for perfection of a security interest, whether the insolvency law should recognize that grace period and include an exception to application of the stay to secured creditors to permit perfection in the applicable circumstances also will need to be considered (see UNCITRAL Legislative Guide to Secured Transactions).

**(a) Specifying the exact time of effect of the stay**

192. As a preliminary issue, regardless of whether an automatic stay is to be applicable by reference to the time of application or commencement, it is important that an insolvency law address the question of the exact time at which the stay will become effective to ensure protection of the estate, especially in relation to payments. Different approaches are taken to this issue. In some laws, the stay becomes effective as of the time of the court's decision to commence proceedings, in others when the decision as to commencement becomes publicly available, while in yet other laws the stay has effect retroactively from the first hour of the day of the commencement order. A similar diversity of approaches is taken where the stay has effect upon the making of the application for commencement of proceedings. Whichever approach is adopted, the insolvency law should contain a clear rule.

**(b) Application of the stay from the time an application for commencement is made**

193. With respect to the point at which the stay should take effect, one approach applies the stay from the making of an application for either liquidation or reorganization proceedings, irrespective of whether it is a debtor or creditor application. This approach may avoid the need to consider the availability of interim or provisional measures of protection to cover the period between the making of the application and the commencement of proceedings, but will require the application of the stay at a time when a number of factual matters are not necessarily clear, in particular whether the debtor will satisfy the commencement criteria. To balance against the risk of abuse in this situation, it is desirable if this approach is followed, that clear procedures for seeking relief from the application of the stay on an expedited basis be included in the insolvency law.

**(c) Application from commencement**

194. The most common approach to application of the stay is for it to apply on commencement of the proceedings, when issues of eligibility, jurisdiction and satisfaction of the commencement criteria will have been resolved and it is clear that proceedings should be commenced rather than the application be denied.

*(i) Provisional measures*

195. In some insolvency laws, the application of the stay on commencement is complemented by provisional measures to address the period between application and commencement to protect the assets of the debtor and the collective interests of creditors. Even where the commencement decision is made quickly, there is the potential in that period for the debtor's business situation to change and for dissipation of the debtor's assets—the debtor may be tempted to transfer assets out of the business, and creditors, on learning of the application, may take remedial action against the debtor to pre-empt the effect of any stay that may be imposed upon commencement of the proceedings. The unavailability of provisional measures in such circumstances could frustrate the objectives of the insolvency proceedings. As with most provisional measures, the need for relief generally must be urgent and must outweigh potential harm resulting from such measures.

196. Where an insolvency law permits provisional measures to be granted, it is important that it also make provision for periodic review and, if necessary, renewal

of provisional measures by the court and address what happens to those measures on commencement of the insolvency proceedings. In many instances there will be no need for provisional measures to continue to apply after the commencement of proceedings, as they will be superseded by the measures automatically applicable on commencement. If, however, provisional relief of a particular kind is not provided by the measures automatically applicable on commencement, and that type of relief is still required after commencement, the court in appropriate circumstances may extend the application of that provisional measure.

(ii) *Types of provisional measures*

197. Provisional measures may be available on the application of the debtor, creditors, or third parties or be ordered by the court on its own motion. They may include: appointing an interim insolvency representative or other person (not including the debtor) to administer or supervise the debtor's business and to protect assets and the interests of creditors; prohibiting the debtor from disposing of assets; taking control of some or all of the debtor's assets; suspending enforcement by creditors of security rights against the debtor; staying any action by creditors against the debtor's assets, such as by a secured creditor or retention of title holder; or preventing the commencement or continuation of individual actions by creditors to enforce their claims. Where an insolvency representative is appointed as a provisional measure, it may not have powers as broad as those of an insolvency representative appointed on commencement of proceedings and its functions may be limited to protecting assets and the interests of creditors. It may be given, for example, the power to use and dispose of the debtor's assets in the ordinary course of business and to realize those assets in whole or in part in order to protect and preserve the value of assets that, by their nature or because of other circumstances are perishable, susceptible to devaluation or otherwise in jeopardy. In any event, it may be necessary to determine the balance of responsibilities between the insolvency representative and the debtor with respect to the operation of the debtor's business, bearing in mind that at that point no determination as to commencement of insolvency proceedings has yet been made. Where proceedings are not commenced, significant harm to the debtor's business or to the rights of creditors may result. In general, the debtor would continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

(iii) *Evidentiary requirements*

198. Since these measures are provisional in nature and are granted before the court's determination that the commencement criteria have been met, the law may require the court to be satisfied that there is some likelihood that the debtor will satisfy the commencement requirements. Where a party other than the debtor applies for the measure, the applicant may be required by the court to provide evidence that the measure is necessary to preserve the value or avoid dissipation of the debtor's assets. In that case, some form of security for costs, fees or damages, such as the posting of a bond, may also be required in case proceedings are not subsequently commenced or the measure sought results in some harm to the debtor's business. Where provisional measures are improperly obtained, it may be appropriate to permit the court to assess costs, fees and damages against the applicant for the measure.

(iv) *Notice of application and orders for provisional measures*

199. The insolvency law may also need to consider the question of provision of notice, both in respect of the application for provisional measures and of an order for provisional measures (including the time at which those measures become applicable), and the parties to whom that notice needs to be given. As a general principle, the debtor should be given notice of an application for provisional measures and an opportunity to challenge the application. Only in exceptional circumstances is it desirable that notice to the debtor be dispensed with and the application proceed on an ex parte basis. While many laws allow ex parte applications for provisional measures, they generally do so on the basis that the applicant provides security for costs and damages and can demonstrate requisite urgency, i.e. that irreparable harm will result if the applicant is required to seek the requested measure under customary procedures requiring many days' notice.<sup>36</sup> Nevertheless, once an order for provisional measures has been made on an ex parte basis, the debtor would generally be entitled to notice of the order and an opportunity to be heard. Bearing in mind the need to avoid unnecessary damage to a debtor against whom insolvency proceedings are not subsequently commenced, notice of an order for provisional measures may need to be given only to parties directly affected by the order.

(v) *Relief from provisional measures*

200. Relief from the application of provisional measures, such as modification or termination, may be appropriate in cases where the interests of the persons to whom the measures are directed are being harmed by their application. Examples of situations where relief might be appropriate would include those involving perishable goods, actions relating to preservation or quantification of a claim against the debtor and secured creditors (see para 206 below). The granting of such relief may need to be balanced against potential detriment to the interests of creditors generally or to the debtor's assets. Such relief might be available on the application of the affected party, the insolvency representative or on the motion of the court itself, and would generally require notice to be given to the person or persons affected by the modification or termination and an opportunity to challenge the modification or termination.

## **6. Duration of application of the stay**

### **(a) Unsecured creditors**

201. Many insolvency laws provide for the stay to apply to unsecured creditors throughout both liquidation and reorganization proceedings. In liquidation, this would generally mean when the liquidation of the assets had been completed and the proceedings closed. In reorganization, some laws provide that the proceedings will end when the reorganization plan is approved and effective, while others delay closure until the plan is fully implemented. Application of the stay until that later time may be unnecessary on the basis that the reorganization plan should address the claims of unsecured creditors who would be bound by the approved plan.

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<sup>36</sup> See UNCITRAL work on interim measures in support of arbitration: document A/CN.9/WG.II/WP.119 [Yearbook 2001, Part two].

202. Relief from the application of the stay may be provided to unsecured creditors in particular instances such as those noted above with respect to quantification or preservation of a claim (see chapter II.B.3(a) above).

**(b) Secured creditors**

*(i) Reorganization*

203. [91] It may be desirable for the stay to apply to secured creditors for a sufficient period of time to ensure that the reorganization can be conducted in an orderly manner without the possibility of assets being separated before the reorganization can be finalised. To avoid delay and encourage a speedy resolution of the proceedings, there may be advantage in limiting the application of the stay to the time that it may reasonably take for a reorganization plan to become effective to avoid application of the stay for an uncertain or unnecessarily lengthy period, provided that the period is not allowed to continue for years without a plan being proposed and approved. Such a limitation may also have the advantage of providing secured creditors with a degree of certainty and predictability as to the duration of the period of interference with their rights and the treatment of those rights in the plan. Alternatively a fixed time period might be specified. The difficulty with establishing a fixed time limit, however, is that it may not always be sufficiently long, depending on the size and complexity of the reorganization and the plan required, and may be difficult to enforce. Solutions may include establishing clear time limits, with the possibility of extension (see below), or providing for relief from the stay in certain circumstances (see below). It is important that the overall design of the insolvency law encourages speedy and efficient progress of the proceedings, enabling the period for application of the stay to secured creditors, particularly in reorganization, to be minimized.

*(ii) Liquidation*

204. Insolvency laws adopt different approaches in respect of application of the stay to secured creditors in liquidation. Of those laws applying the stay to secured creditors, some adopt the approach that the stay automatically applies upon commencement of liquidation proceedings but only for a brief period, such as 30 or 60 days. This period is to allow the insolvency representative to assume its duties and take stock of the assets and liabilities of the estate and to determine the best means of achieving liquidation of the assets. In those cases where the encumbered asset is essential to the sale of the business as a going concern, some laws provide that application of the stay may be extended beyond the specified period. Where the encumbered asset is not required for the sale of the business, however, the stay could be lifted (see below). Another approach extends the stay to secured creditors for the duration of the liquidation proceedings, subject to a court order for relief where it can be shown that the value of the encumbered asset is being eroded and cannot be maintained.

**7. Extension of the duration of the stay**

205. Where the stay applies for a specified period, the law may include provision for extension of the stay. Experience in some countries suggests that extension of the stay has been treated as a routine matter with the result that stays have been extended for periods of up to several years, ultimately defeating the purpose of the



proceedings and destroying any value that may have been available for creditors at the outset. To avoid this situation, it is desirable that an insolvency law provide clear rules on the availability of extensions, limiting the parties that may apply and the grounds upon which an extension should be granted. An extension may be available, for example, on the application of the insolvency representative when it can be demonstrated that an extension is required in order to maximize value (e.g. there is a reasonable possibility that the debtor, or business units of the debtor, can be sold as a going concern) provided that it is not detrimental to the interests of secured creditors. To provide additional protection and avoid the stay being applied for an uncertain or unnecessarily lengthy period, it is desirable that an insolvency law limit the period for which the stay can be extended and, possibly, the number of times an extension is available.

## **8. Protection of secured creditors**

206. As noted above, where secured creditors are included in the scope of the stay, the insolvency law can adopt certain measures to protect their interests. In addition to limiting the duration of the stay, these measures may include providing for the stay to be lifted and adopting measures to ensure, where the value of the secured claim is more than or close to the value of the encumbered asset, that the value of the encumbered asset is protected against diminution, either as a result of the use of the asset or because of the application of the stay. Since these measures are interrelated, it is desirable that an insolvency law adopt a coherent approach. Where the length of the application of the stay is short, for example, there may be no need for the law to require protection of the value of the encumbered assets. Where the stay applies for a long time, however, lifting of the stay may be a more cost effective remedy than providing protection for the value of the asset, provided the asset is not required for the proceedings. The interests of secured creditors can, of course, also be protected more generally, by consulting them on the use and sale of the encumbered assets; the payment of interest as far as the proceeds of the asset allow; and taking over the asset where the asset is worth less than the secured claim. These measures are discussed in the following sections. The desirability of approaches that provide protection for the value of the encumbered asset may need to be weighed against the potential complexity and cost of those measures and the need for the court to be able to make difficult commercial decisions on the question of protection. Where protection is provided, it may be desirable for an insolvency law to provide guidance to determine when and how creditors holding some type of security interest over the debtor's assets would be entitled to the types of protection described below.

### **(a) Relief from the stay**

207. In liquidation and reorganization proceedings, circumstances may arise where it is appropriate to provide relief from the stay. The secured creditor may be permitted to apply to the court for that relief or the insolvency representative (without the approval of the court) may be permitted to release the security. Relevant circumstances may include where the value of the secured creditor's claim exceeds the value of the encumbered asset; where the secured creditor is not receiving protection for the erosion of the value of the encumbered asset; where the provision of protection may not be feasible or would be overly burdensome to the estate; where the encumbered asset is not needed for the reorganization or sale of

the business as a going concern in liquidation; where relief is required to protect or preserve the value of assets, such as perishable goods; or where, in reorganization, a plan is not approved within any applicable time limit.

208. Where relief from the stay is granted, the insolvency law may provide for the encumbered asset to be turned over to the secured creditor in which case the asset will cease to be part of the estate and the secured creditor will be free to enforce its rights. Under some laws the insolvency representative may be required to decide whether the asset should be turned over to the secured creditor or whether the asset can be relinquished. The difference between these options may have cost implications for the estate. For example, where the asset is a large piece of equipment, turning it over to the creditor may require expenditure by the estate for transport, while relinquishment places the costs of removal on the creditor.

209. While provisions on relief from the stay principally address the interests of secured creditors, there are examples of insolvency laws which provide that relief from the stay may be granted to an unsecured creditor. This may be relevant, for example, where goods are perishable and in those cases where the insolvency law does not allow commencement or continuation of claims, to allow a claim to be determined in another forum where litigation may be well advanced and it would be efficient for it to be completed, or a claim against an insurer of the debtor to be pursued.

**(b) Protection of value**

210. Some insolvency laws adopt provisions specifically designed to address the negative impact of the stay on secured creditors by maintaining the economic value of secured claims during the period of the stay (in some jurisdictions referred to as “adequate protection”).

*(i) Protecting the value of the encumbered asset*

211. Where the estate is able to maintain the value of encumbered assets, it can be approached in several ways. One approach is to protect the value of the encumbered asset itself on the understanding that, upon liquidation, the proceeds of sale of the encumbered asset will be distributed directly to the creditor to the extent of the secured portion of their claim. This approach may require a number of steps to be taken.

212. During the period of the stay it is possible that the value of the encumbered asset will diminish. Since, at the time of eventual distribution, the extent to which the secured creditor will receive priority will be limited by the value of the encumbered asset, such a depreciation can prejudice the secured creditor. Some insolvency laws provide that the insolvency representative should protect secured creditors against any diminution either by providing additional or substitute assets or making periodic cash payments corresponding to the amount of the diminution in value. This approach is only necessary where the value of the encumbered asset is less than the amount of the secured claim. If the value exceeds the claim, the secured creditor will not be harmed by the erosion of value until that value becomes insufficient to pay the secured claim. Some countries that preserve the value of the encumbered asset as outlined also allow for payment of interest during the period of the stay to compensate for delay imposed by the proceedings. Provision of interest

may be limited however to the extent that the value of the encumbered asset exceeds the value of the secured claim. Otherwise, compensation for delay may deplete the assets available to unsecured creditors. Such an approach may encourage lenders to seek security that will adequately protect the value of their claims.

#### *Valuation of encumbered assets*

213. Central to the notion of protecting the value of encumbered assets is the mechanism for determining the value of those assets in order to enable the court to determine whether and how much to provide to secured creditors as relief against the erosion of the value of encumbered assets during the proceedings. This is a potentially complex issue and involves questions of the basis on which the valuation should be made (e.g. going concern value or liquidation value), the party to undertake the valuation and the relevant date for determining value, such as the date of commencement, with provision for ongoing review. One approach is for the valuation assessment, at least in the first instance, to be determined through agreement by the parties (being the debtor, or insolvency representative, and the secured creditor). Other laws provide different court-based approaches. For example, rather than undertaking the valuation itself, the court may specify a mode of determining the value, which might be carried out by appropriate experts. This could be supported by clearly stated principles in the insolvency law upon which the valuation might be based. An alternative approach is for the court, possibly following an initial estimate or appraisal of value by the insolvency representative, to determine the value on the basis of evidence, which might include a consideration of markets, market conditions and expert testimony. Some laws require a market valuation of an asset through sale, whereby the highest price available in the market for the asset is obtained via tender or auction. This valuation technique is less applicable to protection of either the value of the encumbered asset or the secured claim (see below) than it is to disposal of assets of the estate by the insolvency representative. Valuation is also relevant for the process, at commencement, of registering all assets and liabilities, and preparing a net balance of the debtors position (see chapter V.A.3(b)(iii)).

214. In some liquidation cases the insolvency representative may find it necessary to use or sell encumbered assets (see chapter II.C) in order to maximize the value of the estate. For example, in liquidation to the extent that the insolvency representative is of the view that the value of the estate can best be maximized if the business continues to operate for a temporary period, it may wish to sell inventory that is partially encumbered. In reorganisation proceedings also, it may be in the best interests of the estate to sell encumbered assets of a similar nature to provide needed working capital. Thus, in cases where secured creditors are protected by preserving the value of the encumbered asset, it may be desirable for an insolvency law to allow the insolvency representative the choice of providing the creditor with substitute equivalent security, such as a replacement lien over another asset or the proceeds of the sale of the encumbered asset, or paying out the full amount of the value of the assets that secure the secured claim either immediately or through an agreed payment plan. Other approaches focus on the use of the proceeds of the sale of the encumbered assets (see chapter II.C). One method is for the court to prevent current or future use of those proceeds by the insolvency representative. Other laws grant secured creditors relief from the stay to pursue individual remedies regarding such proceeds, or where use of the proceeds is not authorised by either the secured

creditor or the court, hold the debtor, its management or the insolvency representative personally liable for the amount of the proceeds, or make such debt non-dischargeable.

(ii) *Protecting the value of the secured portion of the claim*

215. A second approach to protecting the interests of secured creditors is to protect the value of the secured portion of the claim. Immediately upon commencement, the encumbered asset is valued and, based on that valuation, the amount of the secured portion of the creditor's claim is determined. This amount remains fixed throughout the proceedings and, upon distribution following liquidation, the secured creditor receives a first-priority claim to the extent of that amount. During the proceedings, the secured creditor could also receive the contractual rate of interest on the secured portion of the claim to compensate for delay imposed by the proceedings.

**9. Limitations on disposal of assets by the debtor**

216. In addition to measures designed to protect the insolvency estate against the actions of creditors and third parties, insolvency laws (as noted above, see chapter II.A.2(e)) generally adopt measures which are intended to limit the extent to which the debtor can deal with the assets of the estate. These measures generally will apply after proceedings have commenced, but may in some cases also apply between the time of an application for commencement and commencement itself. For example, where an interim insolvency representative is appointed as a provisional measure before commencement of the proceedings, the debtor may be subject to supervision or control of that insolvency representative, and generally have limited powers to deal with its assets. Under some insolvency laws, this period will only occur in the case of a creditor application because a debtor application will function to automatically commence the proceedings.

217. Where an insolvency representative is appointed on commencement of the insolvency proceedings, many insolvency laws provide that the debtor will lose either all control of the insolvency estate and will not be able to enter into any transactions after commencement, or will have continuing, but limited, powers in relation to the day-to-day conduct of the business and can enter into transactions only in the ordinary course of business. Transactions that do not fall into that category, such as the sale of significant assets, may require authorization by the insolvency representative, the court or in some cases, the creditors.<sup>37</sup>

218. Where the debtor enters into an unauthorized transaction, whether between application and commencement or after commencement, the effect generally would be that any property transferred should be returned to the insolvency representative and any obligations created would be unenforceable against the estate. There may be concerns, however, about the counterparty to the transaction, especially where that party entered into the transaction in good faith and gave value for what was received. For that reason, some insolvency laws provide for those transactions to be valid in certain circumstances. These might include, for example, situations where the transfer was of an immovable and was made before the commencement of the insolvency was notified in the relevant registry or where a third party holding certain assets of the debtor transferred them to another party in good faith and

<sup>37</sup> Further aspects of these transactions are discussed in chapters II.A.2(e), II.C and II.E.7.

without any knowledge of the commencement of insolvency proceedings. While operating to protect an innocent third party, the inclusion of such a provision will operate to reduce the assets potentially available to creditors. For that reason, it is desirable that if any such provision is to be included in an insolvency law, it be narrowly framed. Because the delay between commencement and notification of commencement can be central to the occurrence of these transfers, it is essential that the requirements for giving notice of commencement result in early and effective notification (see chapter I.B).

219. Some insolvency laws address contracts entered into and transactions implemented by the debtor between application and commencement that are not authorized, whether by the insolvency law, the insolvency representative, the court or creditors (as required), in terms of the avoidance provisions (see chapter II.F), and apply the suspect period retrospectively from commencement of proceedings.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions on the protection and preservation of the estate is to:

- (a) establish measures to ensure the value of the estate is not diminished by the actions of the debtor, creditors or third parties;
- (b) determine the scope of those measures and the parties to whom they apply;
- (c) establish the method, time and duration of application of those measures;
- (d) establish the grounds for relief from those measures.

### Contents of legislative provisions

#### *Provisional measures*<sup>38</sup>

(27) The law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor<sup>39</sup> or the interests of creditors, between the making of an application to commence insolvency proceedings and commencement of the proceedings,<sup>40</sup> including:

- (a) staying execution against the assets of the debtor, including [perfection] [actions to make security interests effective against third parties] or enforcement of security interests;

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<sup>38</sup> These articles follow the corresponding articles of the Model Law on Cross-Border Insolvency, see Art. 19 UNCITRAL Model Law on Cross-Border Insolvency.

<sup>39</sup> The reference to assets in paragraphs (a) to (c) is intended to be limited to assets that would be part of the insolvency estate.

<sup>40</sup> The law should indicate the time of effect of an order for provisional measures e.g. at the time of the making of the order, retrospectively from the commencement of the day on which the order is made or some other specified time.

(b) entrusting the administration or supervision of the debtor's business, which may include the power to use and dispose of assets in the ordinary course of business, to an insolvency representative or other person<sup>41</sup> designated by the court;

(c) entrusting the realization of all or part of the assets of the debtor to an insolvency representative or other person designated by the court, in order to protect and preserve the value of assets of the debtor that, by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy; and

(d) any other relief of the type applicable automatically on commencement of proceedings.

*Indemnification in connection with provisional measures*

(28) The law may provide the court with the power to:

(a) require the applicant for provisional measures to provide indemnification and, where appropriate, to pay costs or fees; or

(b) impose sanctions in connection with an application for provisional measures.

*Balance of rights between debtor and insolvency representative*

(29) The law should clearly specify the balance of the rights and obligations between the debtor and any insolvency representative appointed as a provisional measure. Between the time of an application for commencement of insolvency proceedings and commencement of those proceedings, the debtor is entitled to continue to operate its business and to use and dispose of assets in the ordinary course of business, except to the extent restricted by the court.

*Notice*

(30) The law should specify that, unless the court limits or dispenses with the need to provide notice, appropriate notice be given to those parties in interest affected by:

(a) an application or court order for provisional measures (including an application for review and modification or termination); and

(b) a court order for additional measures applicable on commencement, unless the court limits or dispenses with the need to provide notice.

(31) The law should specify that where the debtor or other party in interest affected by a provisional measure is not given notice of the application for that provisional measure, [within a specified number of days] [upon urgent application] [within a reasonable period of time] [promptly]<sup>42</sup> the debtor or other party in interest affected by the provisional measures has the right to be heard on whether the relief should be continued.

<sup>41</sup>The term "other person" in recommendation (27)(b) and (c) is not intended to include the debtor.

<sup>42</sup> Any time limit included in the law should be short in order to prevent the loss of value of the debtor's business.

*Modification or termination of provisional measures*

(32) The law should specify that the court, at its own motion or at the request of the insolvency representative, the debtor, a creditor or any other person affected by the provisional measures, may review and modify or terminate those measures.

*Termination of provisional measures on commencement*

(33) The law should specify that provisional measures terminate when the measures applicable on commencement take effect, unless the court continues the effect of the provisional measures.

*Measures applicable on commencement*

(34) The law should specify that, on commencement of insolvency proceedings:<sup>43</sup>

(a) commencement or continuation of individual actions or proceedings<sup>44</sup> concerning the assets of the debtor, and the rights, obligations or liabilities of the debtor are stayed;

(b) [perfection] [actions to make security interests effective against third parties] or enforcement of security interests are stayed;<sup>45</sup>

(c) execution or other enforcement against the assets of the estate is stayed;

(d) the right of a counterparty to terminate any contract with the debtor is suspended;<sup>46</sup> and

(e) the right to transfer, encumber or otherwise dispose of any assets of the estate is suspended.<sup>47</sup>

*Exceptions to the application of the stay*

(35) The law may permit exceptions to the application of the stay or suspension under recommendation (34) and where it does so, those exceptions should be clearly stated. Paragraph (a) of recommendation (34) should not affect the right to

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<sup>43</sup> These measures would generally be effective as at the time of the making of the order for commencement.

<sup>44</sup> See Art. 20 UNCITRAL Model Law on Cross-Border Insolvency. It is intended that the individual actions referred to in paragraph (a) of recommendation (34) would also cover actions before an arbitral tribunal. It may not always be possible, however, to implement the automatic stay of arbitral proceedings, such as where the arbitration does not take place in the State but in a foreign location.

<sup>45</sup> Where a secured transactions regime provides a grace period for perfection of a security interest, whether the insolvency law should recognize that grace period and include an exception to application of the stay to secured creditors to permit perfection in the applicable circumstances will need to be considered (see UNCITRAL Legislative Guide to Secured Transactions).

<sup>46</sup> See chapter II.D(2)(a). This recommendation is not intended to preclude the termination of a contract if the contract provides for a termination date that happens to fall after the commencement of insolvency proceedings.

<sup>47</sup> The limitation on the right to transfer, encumber or otherwise dispose of assets of the estate may be subject to an exception in those cases where the continued operation of the business by the debtor is authorised and the debtor can transfer, encumber or otherwise dispose of assets in the ordinary course of business.

commence individual actions or proceedings to the extent necessary to preserve a claim against the debtor.<sup>48</sup>

*Additional measures available on commencement*

(36) The law should specify that the court may grant relief additional to the measures applicable on commencement.<sup>49</sup>

*Duration of measures automatically applicable on commencement*

(37) The law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout the insolvency proceedings until:

- (a) the court grants relief from the measures;<sup>50</sup>
- (b) in reorganization proceedings, a reorganization plan becomes effective;<sup>51</sup>
- (c) in the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires,<sup>52</sup> unless it is extended by the court for a further period on a showing that:
  - (i) an extension is necessary to maximize the value of assets for the benefit of creditors; and
  - (ii) the secured creditor will be protected against the erosion of the value of the encumbered asset.

*Relief from measures applicable on commencement*

(38) The law should specify that a secured creditor may request the court to grant relief from the type of measures applicable on commencement on grounds that may include that:

- (a) the encumbered asset is not necessary to a prospective reorganization or sale of the debtor's business;
- (b) [where the value of the secured claim exceeds the value of the encumbered asset] the value of the encumbered asset is eroding and the secured creditor is not protected against the erosion of that value;
- (c) in reorganization, a plan is not approved within any applicable time limits.

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<sup>48</sup> See Art. 20(3), and paras. 151-152 of the Guide to Enactment of the UNCITRAL Model Law on Cross-Border Insolvency. Where an issue arises as to quantification of a claim, the court may be requested to consider whether relief from the stay can be provided to enable an action or proceeding to be commenced for that purpose.

<sup>49</sup> The additional relief that may be available will depend upon the types of measures available in a particular jurisdiction and what measures, in addition to the measures applicable on commencement, might be appropriate in a particular insolvency proceeding.

<sup>50</sup> Relief should be granted on the grounds included in recommendation (38).

<sup>51</sup> A plan may become effective upon approval by creditors or following confirmation by the court, depending upon the requirements of the law (see recommendations in chapter V.A).

<sup>52</sup> It is intended that the stay should apply to secured creditors only for a short period of time, such as between 30 and 60 days, and that the law should clearly state the period of application.



*Protection from erosion of the value of the encumbered asset*

(39) The law should specify that a secured creditor may request the court to grant protection. Where the value of the encumbered asset does not exceed the secured claim or will be insufficient to meet the secured claim if the value of the encumbered asset erodes during the imposition of the measures applicable on commencement, protection may include:

- (a) cash payments by the estate;
- (b) provision of additional security; or
- (c) such other means as the court determines.

**C. Use and disposal of assets****1. Introduction**

220. Although as a general principle it is desirable that an insolvency law not unduly interfere with the ownership rights of third parties or the interests of secured creditors, the conduct of insolvency proceedings will often require assets of the insolvency estate, and assets in the possession of the debtor being used in the debtor's business, to continue to be used or disposed of (including by way of encumbrance) in order to enable the goal of the particular proceedings to be realized. This will be especially important in reorganization, but also in liquidation where the business is to be sold as a going concern. It may also be relevant in some cases of liquidation where the business needs to be continued for a short period to enable the value of the assets to be maximized even if they are to be sold off piecemeal. For these reasons, it is desirable that an insolvency law include provisions on the use, or disposal of assets of the insolvency estate (including encumbered assets), and third party-owned assets, addressing the conditions upon which those assets may be used or disposed of and the provision of protection for the interests of third party owners and secured creditors. It may be important to note, in designing such provisions, that other laws may affect the use of these powers in insolvency. In particular, laws prohibiting or restricting foreign ownership in certain sectors of the economy may operate to limit the price that can be obtained for certain assets and in turn affect distributions to creditors.

**2. Assets of the insolvency estate****(a) Ordinary course of business**

221. With respect to use and disposal of assets of the insolvency estate, some insolvency laws draw a distinction between the exercise of these powers in the ordinary course of conducting the business of the debtor and their exercise in other circumstances in terms of who may exercise those powers and the protections that are required. For example, decisions as to use and disposal of property in the ordinary course of business may be taken by the insolvency representative<sup>53</sup> without

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<sup>53</sup> The exercise of these rights by the insolvency representative depends upon the functions of that position under the insolvency law and may be restricted, for example, where the insolvency representative's role is that of a trustee or supervisor and also upon the relative roles assigned to the debtor and insolvency representative (see chapter III.A and B) after commencement of insolvency proceedings, particularly in reorganization.

requiring notice to be given to creditors or a hearing of the court, while use and disposal outside the ordinary course of business may require approval of the court or of the creditors. Some laws extend these rights of use and disposal to a debtor under the supervision or control of an insolvency representative, or to a debtor-in-possession.

222. Any concerns with respect to the exercise of powers of use and disposal by the insolvency representative and the possibility for misuse or defalcation may be addressed in terms of the appointment criteria, including provision of a security bond, an approach adopted by many insolvency laws (see also chapter III.B) and through other measures to address the liability of the insolvency representative.

223. Including a distinction in the insolvency law between disposals made in or outside the ordinary course of business may facilitate the continuing day-to-day operation of the business, both in reorganization and in liquidation where it is to be sold as a going concern, without imposing the complexity of obtaining court approval to conduct routine activities. The requirement for approval in the case of non-routine disposal can act as a check against abuse, such as disposals to related parties. Nevertheless, the insolvency law needs to provide clear guidance on what constitutes dealing in the ordinary course of business to avoid disputes and ensure the proceedings are conducted quickly and efficiently (for a discussion of what may constitute actions in the ordinary course of business see chapter II.F.2).

224. Some insolvency laws also distinguish between different types of assets in terms of how they may be used and the conditions that will apply. Special provision may apply, for example, to perishable or other assets that will diminish in value if not sold quickly, or for cash, or property held jointly by the debtor and another person or held by the debtor subject to a security interest.

**(b) Methods of sale**

225. Where assets of the insolvency estate are to be sold it is important that irrespective of which party may be required to supervise sales, the manner of sale chosen maximizes the value for the estate, and that creditors receive adequate notice of the sale, enabling them to challenge the sale in court if they disapprove. Different approaches are taken to achieving these goals. Many insolvency laws require assets to be sold by auction, with some providing that the creditor committee, or some other creditor representative or the insolvency representative can approve some other means of sale, such as by private contract, if it will be more profitable.

226. As noted above, some insolvency laws give the power of sale in the ordinary course of business to the insolvency representative and impose a duty to obtain the best price reasonably obtainable at the time of sale. Some of those laws also impose limits on the insolvency representative's discretion to choose the method of sale. In cases where the insolvency representative chooses to conduct the sale privately rather than through a public auction, the law may require that the court adequately supervise the sale or that the creditors specifically approve it. Other insolvency laws provide for the court to play a significant role in the sale of assets, with the court fixing the time, the form and the conditions of sale; the insolvency representative plays a subsidiary role in collecting offers and obtaining the views of the creditors.

Some insolvency laws also address issues such as sales to a creditor to offset that creditor's claim and sale of any of the debtor's assets in the possession of a third party to that third party for a reasonable market price. Where assets might be subject to rapid deterioration of value, such as where they are perishable, susceptible to devaluation or otherwise in jeopardy, notification and/or approval of creditors or the court might prove difficult to achieve quickly. In such cases it may be desirable for the law to provide that prior approval is not necessary. While the sale could be confirmed after it has been completed, it would not be feasible to create a possibility of reversing or modifying the sale (except in cases of fraud or collusion) due to the consequential contractual uncertainty, and the very nature of the assets may discount the likelihood of any resale.

227. Although it may be suggested that an insolvency law should specifically preclude a sale to related parties to avoid collusion, absolute prohibition of such a sale may not be necessary provided the sale is adequately supervised and carefully scrutinised before being allowed to proceed, to avoid fraud and collusion. Such supervision or scrutiny may require higher standards in terms of the valuation of assets and disclosure of business relationships.

228. While it may be expected that assets sold in the context of insolvency proceedings will achieve a lower sale price than similar assets sold under normal market conditions, an insolvency law can adopt a number of procedural protections to ensure that the process is fair, that the maximum price is achieved and that, overall, the process for disposal of assets is transparent and well-publicised. Such protections include providing notice to creditors and to prospective purchasers in a manner that will ensure the information is likely to come to the attention of interested parties; allowing creditors to raise their objections or concerns (either with the insolvency representative or the court, as appropriate); requiring assets to be valued by neutral, independent professionals (especially in the case of real estate and specialized property); and in the case of auctions, requiring pre-bidder qualification and minimum prices where appropriate, and preventing and punishing collusion among bidders.

**(c) Use or disposal of encumbered assets**

229. An insolvency law will need to address the question of use or disposal (other than by further encumbrance) of encumbered assets and, in particular, whether the insolvency representative or the secured creditor will have the power to sell those assets. To a large extent, the approach adopted will depend upon whether the insolvency law includes encumbered assets in the insolvency estate; if not the secured creditor will generally be free to enforce its security interest. Where encumbered assets are part of the estate, insolvency laws take different approaches to this issue. In some cases the approach depends upon the application of other provisions of the insolvency law, as well as other law, such as application of the stay (while the stay applies only the insolvency representative can dispose of the assets) and whether encumbered assets can be sold free and clear of interests. It may also depend on the nature of the sale proposed, whether as an individual asset or as an integral part of a sale of the business as a going concern. Some insolvency laws, for example, provide that only the insolvency representative will be able to dispose of encumbered assets in both liquidation and reorganization. Other laws distinguish between liquidation and reorganization; the insolvency representative will be able to

dispose of the assets during reorganization, but in liquidation this ability is time limited and once the insolvency representative's exclusive period has expired, the secured creditor may exercise its rights. Whichever approach is adopted an insolvency law should include requirements for provision of notice to secured creditors and an opportunity for them to object. However, where the claim exceeds the value of the asset or the asset is not required for the proceedings, the insolvency representative may be permitted to relinquish the encumbered asset to the secured creditor without notice.

230. An insolvency law should also outline the conditions for further encumbrance of assets subject to existing security interests, the most common being that the existing secured creditor will have priority for the secured portion of its claim over any new secured creditor (see chapter II.D.3).

**(d) Ability of the insolvency representative to sell free and clear of interests**

231. Some insolvency laws provide that the insolvency representative can sell assets of the estate free and clear of interests, including security interests, subject to certain conditions. These may include that the sale is permitted under general law other than the insolvency law; that the holder of the interest is notified of the proposed sale and consents; that the sale price is in excess of the value of the security interest; that the holder of the security interest could be compelled (in other legal proceedings) to accept cash or substitute equivalent security in settlement of its interest; and that the priority of interests in the proceeds of any sale will be preserved. Some laws also provide that where the holder of the security interest does not consent to the sale, the insolvency representative may apply to the court for authorization of the sale. This may be granted provided the court is satisfied, for example, that the insolvency representative has made reasonable efforts to obtain the consent, that the sale is in the interests of the debtor and its creditors and that the sale will not substantially prejudice the holder of the interest. Even where the court approves the sale, if the offer for the asset was inadequate, the law might permit the holder of the security interest to retain the right to offset the bid to protect its interest.

232. Some advantages of allowing the insolvency representative to sell free and clear are that assets sold subject to these interests are likely to obtain much lower prices and considerable uncertainty will exist for the buyer. Where encumbered assets are subject to conflicting claims (e.g. ownership, lease or lien) the ability to sell free and clear of interests will allow the assets (where they are not unique) to be sold without waiting for the claims to be resolved and the claimants can then dispute the distribution of the proceeds of sale.

**(e) Joint assets**

233. Where assets are owned by the debtor and another person in some form of joint or co-ownership, different approaches may be taken to the disposal of the debtor's interest. Where the assets can be divided under the general law between the debtor and the co-owners for the purposes of execution, the insolvency estate's interest can be sold without affecting the co-owners. Some insolvency laws, however, provide that both the estate's interest and the interest of co-owners may be sold by the insolvency representative where certain conditions are met. These conditions may include that division of the property between the estate and the co-

owners is impractical, that the sale of a divided part would realize significantly less for the estate than a sale of the undivided whole free of the interests of the co-owners, and that the benefit to the estate of such a sale outweighs any detriment to the co-owner. The insolvency law may also provide that the co-owner has an option or right to purchase the debtor's interest before completion of the sale to another party. As noted above (chapter II.A.2) the disposal of such assets in insolvency may be affected by the application of other law.

**(f) Burdensome, no value and hard to realize assets**

234. It may be consistent with the objective of maximizing value and reducing the costs of the proceedings to allow the insolvency representative to relinquish the estate's interest in certain assets, including land, shares, assets subject to a valid security interest, contracts and other property, where the insolvency representative determines relinquishment to be in the interests of the estate, and additionally where a secured creditor obtains relief from the stay. The exercise of that power may be subject to approval by the court and to certain conditions, such as that the relinquishment does not violate any compelling public interest, for example where the asset is environmentally dangerous or hazardous to public health and safety. Situations in which this approach may be appropriate include where assets have a no or insignificant value to the estate, where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable by the insolvency representative, such as where the asset is unique or does not have a readily apparent market or market value. Creditors should be provided with notice of, and given an opportunity to object to, any proposal by the insolvency representative to relinquish assets.

**(g) Receivables**

235. Where the assets of the estate include receivables (the debtor's contractual right to payment of a monetary sum), it may be advantageous for the insolvency representative to be able to assign the rights to payment to obtain, for example, value for the estate or credit. Different approaches are taken to the question of assignment in the context of insolvency (see chapter II.D). Some insolvency laws specify that non-assignment clauses are made null and void by the commencement of insolvency proceedings. Other insolvency laws leave the matter to general contract law. If the contract contains a non-assignment clause then the contract cannot be assigned unless the agreement of the parties to the original contract is obtained. Some laws also provide that if the counterparty to the original contract does not consent to assignment, the insolvency representative may assign with permission from the court if it can be shown that the counterparty is withholding consent unreasonably. The insolvency representative is then free to assign the contract for the benefit of the estate. This approach is consistent with the approach taken in the UNCITRAL Convention on the Assignment of Receivables in International Trade (2001), article 9.<sup>54</sup>

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<sup>54</sup> Article 9 Contractual limitations on assignments:

1. An assignment of a receivable is effective notwithstanding any agreement between the initial or any subsequent assignor and the debtor or any subsequent assignee limiting in any way the assignor's right to assign its receivables.

### 3. Third party owned assets

236. There will be insolvency cases where third party owned assets, similarly to encumbered assets, may be crucial to the continued operation of the business, particularly in reorganization proceedings but also to a lesser extent in some liquidation proceedings where the business is to be sold as a going concern. In those cases, it will be advantageous for an insolvency law to provide some mechanism that will enable these assets to continue to be used in the insolvency proceedings. Some insolvency laws address this issue in terms of the types of assets to be included as part of the insolvency estate (see chapter II.A.2(c) and 3(a)). Other insolvency laws, where the possession of the asset by the debtor is subject to a contractual arrangement, address it in the context of the treatment of contracts (see chapter II.E). This may include, for example, imposing restrictions on the termination of the contract pursuant to which the debtor holds the assets (see chapter II.E.2(a)), or preventing the owner from reclaiming its assets in the insolvency (at least without the approval of the court or the insolvency representative) for a limited period of time after commencement by imposing of a stay.

237. Where third party owned assets are used in the insolvency proceedings, an insolvency law will need to consider protection of the interests of the owner of the assets against diminution in their value, in much the same way as protection is provided for secured creditors against diminution in the value of encumbered assets (see chapter II.B.3(b)). It is desirable that any benefits conferred on the estate by the continued use of the asset be paid for by the estate as an expense of administering the estate (see chapter II.E).

### 4. Treatment of cash proceeds

238. Where “liquid” encumbered assets, i.e. encumbered assets, such as inventory, that are easily converted to cash, are sold in the course of insolvency proceedings, most laws provide that a secured creditor with an interest in an encumbered asset continues to hold an equivalent interest in any cash derived from the disposal of that asset.

239. Those cash proceeds can represent an important source of capital for the insolvency estate during the course of insolvency proceedings, especially in reorganization, and may be used for a number of purposes associated with the running of the business, such as payment of electricity and other service charges. In order to use cash proceeds, an insolvency representative must generally pursue one of two courses of action. Cash proceeds may be used with the consent of the relevant secured creditor on the terms agreed between the parties or, alternatively,

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2. Nothing in this article affects any obligation or liability of the assignor for breach of such an agreement, but the other party to such agreement may not avoid the original contract or the assignment contract on the sole ground of that breach. A person who is not party to such an agreement is not liable on the sole ground that it had knowledge of the agreement.

3. This article applies only to assignments of receivables:

(a) Arising from an original contract that is a contract for the supply or lease of goods or services other than financial services, a construction contract or a contract for the sale or lease of real property;

(b) Arising from an original contract for the sale, lease or licence of industrial or other intellectual property or of proprietary information;

(c) Representing the payment obligation for a credit card transaction; or

(d) Owed to the assignor upon net settlement of payments due pursuant to a netting agreement involving more than two parties.

following provision of notice to effected creditors, the debtor may seek a court order to use the cash proceeds. In general, a court will make three inquiries before authorizing such use: both the relevant security interest and the value of the underlying property will need to be determined; the risk to the secured creditor will need to be identified; and the court will need to determine whether sufficient measures are in place to protect the economic value of the secured claim (see chapter II.B. 8(b))

## Recommendations

### Purpose of legislative provisions

The purpose of provisions on use and disposal of assets is to:

- (a) permit the use of assets, including encumbered assets and assets owned by a third party in the insolvency proceedings and specify the conditions for their disposal;
- (b) establish the limits to powers of use and disposal;
- (c) provide notice to creditors of proposed disposal, where appropriate;
- (d) provide for the treatment of burdensome assets.

### Contents of legislative provisions

#### *Power to use and dispose of assets of the estate*

(40) The law should permit:

- (a) the use and disposal of assets of the estate (including assets subject to security interests) in the ordinary course of business;
- (b) the use or disposal of assets of the estate (including assets subject to security interests) other than in the ordinary course of business, subject to the requirements of recommendations (41) and (44).

#### *Notification and publication of disposal*

(41) The law should specify that adequate notice of any disposal conducted outside the ordinary course of business is given to creditors<sup>55</sup> and that they have the opportunity to object.

(42) The law should specify that public auctions are publicised in a manner that will ensure the information is likely to come to the attention of interested parties.

#### *Ability to sell assets of the estate free and clear of encumbrances and other interests*

##### *- Sale in the ordinary course of business*

(43) The law may permit the insolvency representative to sell assets of the estate free and clear of encumbrances and other interests, in the ordinary course of business, provided that:

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<sup>55</sup> When the assets used in the insolvency proceedings are encumbered assets, that use will also be subject to recommendation (43).

- (a) the insolvency representative gives notice of the proposed sale to the holders of encumbrances or other interests;
- (b) the holders are given the opportunity to object to the proposed sale;
- (c) relief from the stay has not been granted;
- (d) the priority of interests in the proceeds of sale of the asset is preserved.

*- Sale outside the ordinary course of business*

[(44) The law may permit the insolvency representative to sell assets of the estate free and clear of encumbrances and other interests outside the ordinary course of business provided that the requirements of recommendations (41) and (43) are met.]

*General methods of sale*

(45) The law should specify methods of sale for sales conducted outside the ordinary course of business that will maximize the price obtained for assets being sold in insolvency proceedings, and permit both public auctions and private sales.

*Urgent sales*

(46) The law should permit urgent sales of assets to be conducted outside the ordinary course of business, where the assets by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy. The law may provide that prior approval of the court or of creditors is not required in such circumstances.

*Disposal of assets to related persons*

(47) The law should require any proposed disposal of assets to related persons to be carefully scrutinised before being allowed to proceed.

*Burdensome assets*

(48) The law should permit the insolvency representative to determine the treatment of any assets that are burdensome to the estate. In particular, the law may permit the insolvency representative to relinquish burdensome assets following the provision of notice to creditors and the opportunity for creditors to object to the proposed action, except that where a secured claim exceeds the value of the encumbered asset, and the asset is not required for a reorganization or sale of the business as going concern, the law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors.

## **D. Post-commencement finance**

### **1. Need for post-commencement finance**

240. The continued operation of the debtor's business after the commencement of insolvency proceedings is critical to reorganization and, to a lesser extent, liquidation where the business is to be sold as a going concern. To maintain its business activities, the debtor must have access to funds to enable it to continue to



pay for crucial supplies of goods and services, including labour costs, insurance, rent, maintenance of contracts and other operating expenses, as well as costs associated with maintaining the value of assets. In some insolvency cases, the debtor may already have sufficient liquid assets to fund the ongoing business expenses in the form of cash or other assets that can be converted to cash (such as anticipated proceeds of receivables). Alternatively, those expenses can be funded out of the debtor's existing cash flow through operation of the stay and cessation of payments on pre-commencement liabilities. Where the debtor has no available funds to meet its immediate cash flow needs, it will have to seek financing from third parties. This financing may take the form of trade credit extended to the debtor by vendors of goods and services, or loans or other forms of finance extended by lenders.

241. To ensure the continuity of the business where this is the object of the proceedings, it is highly desirable that a determination on the need for new finance is made at an early stage, in some cases even in the period between the making of the application and commencement of proceedings. Beyond that initial period, particularly in reorganization proceedings, the availability of new finance will also be important after commencement of the proceedings and before consideration of the plan; obtaining finance in the period after approval of the plan generally should be addressed in the plan, especially in those jurisdictions which prohibit new borrowing unless the need for it is identified in the plan.

242. Notwithstanding that it might be desirable for the proceedings for the debtor to be able to obtain new money, a number of jurisdictions restrict the provision of new money in insolvency or do not specifically address the issue of new finance or the priority for its repayment in insolvency, creating uncertainty. Under some laws, for example, new money can only be provided on the basis of security as provision of a preference for new lending is prohibited. In those cases where there are no unencumbered assets that the debtor can offer as security or no excess value in already encumbered assets, no new money will be available unless the lender is prepared to take the risk of lending without security or unless it can be obtained from sources such as the debtor's family or group companies. The provision of finance in the period before commencement may also raise difficult questions relating to the application of avoidance powers and the liability of both the lender and the debtor. Some insolvency laws provide, for example, that where a lender advances funds to an insolvent debtor, it may be responsible for any increase in the liabilities of other creditors or the advance will be subject to avoidance in any ensuing insolvency proceedings. In other examples, the insolvency representative is required to borrow the money, potentially involving questions of personal liability for repayment.

243. Where an insolvency law promotes the use of insolvency proceedings that require the insolvent business to continue trading, whether it be reorganization or sale of the business in liquidation as a going concern, it is essential that the issue of new funding is addressed and limitations such as those discussed above are considered. An insolvency law can recognize the need for such post-commencement finance, provide authorization for it and create priority for repayment of the lender. The central issue is the scope of the power, and in particular, the inducements that can be offered to a potential creditor to encourage it to lend. To the extent that the solution adopted impacts the rights of existing secured creditors or those holding an

interest in assets that was established prior in time, it is desirable that provisions addressing post-commencement finance are balanced against the general need to uphold commercial bargains, protect the pre-existing rights and priorities of creditors and minimize any negative impact on the availability of credit, in particular secured finance, that may result from interfering with those pre-existing security rights and priorities. It is also important to consider the impact on unsecured creditors who may see the remaining unsecured assets disappear to secure new lending, leaving nothing available for distribution, especially if the reorganisation were to fail.

244. In addition to issues of availability and security or priority for new lending, an insolvency law will need to consider the authorization required to obtain that new money (discussed further below) and, where a reorganization fails and the proceedings are converted to liquidation, the treatment of funds that may have been advanced before the conversion (discussed further below).

## **2. Sources of post-commencement finance**

245. Post-commencement lending is likely to come from a limited number of sources. The first is pre-insolvency lenders or vendors of goods who have an ongoing relationship with the debtor and its business and may advance new funds or provide trade credit in order to enhance the likelihood of recovering their existing claims and perhaps gaining additional value through the higher rates charged for the new lending. A second type of lender has no pre-insolvency connection with the business of the debtor and is likely to be motivated only by the possibility of high returns. The inducement for both types of lender is the certainty that special treatment will be accorded to the post-commencement finance. For existing lenders there are the additional inducements of the ongoing relationship with the debtor and its business, the assurance that the terms of their pre-commencement lending will not be altered and under some laws, the possibility that, if they do not provide post-commencement finance, their priority may be displaced by the lender who does provide that finance.

## **3. Attracting post-commencement finance—providing security or priority**

246. A number of different approaches can be taken to attracting post-commencement finance and providing for repayment, including the provision of security on unencumbered or partially encumbered assets or, where that option is not available, establishing a priority.

### **(a) Granting security**

247. Where the lender requires security, it can be provided on unencumbered property or as a junior or lower security interest on already encumbered property where the value of the encumbered asset is significantly in excess of the amount of the pre-existing secured obligation. In that case, no special protections will generally be required for the pre-existing secured creditor, as their rights will not be adversely affected unless circumstances change at a later time (such as that the value of the encumbered assets begin to erode) and they will retain their pre-commencement priority in the encumbered asset, unless they agree otherwise. Frequently, the only unencumbered assets that may be available for securing post-commencement finance will be assets recovered through avoidance proceedings.

**(b) Establishing priority**

248. Where the approaches discussed above are either insufficient or not available, for example because there are no unencumbered assets or there is no excess value in those assets already encumbered, insolvency laws adopt a variety of approaches to encouraging the provision of new finance.

249. Some insolvency laws provide that new lending will be afforded some level of priority over other creditors, in some cases including existing secured creditors. One level of priority is classed as an administrative priority (see chapter V.B), which will rank ahead of ordinary unsecured creditors, but not ahead of a secured creditor with respect to its security. In some cases, this priority is afforded on the basis that the new lending is extended to the insolvency representative, rather than to the debtor, and becomes an expense of the insolvency estate. Some insolvency laws require such borrowing to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary finance without approval, although this may involve an element of personal liability and, where it does, is likely to result in reluctance to seek new finance.

250. Other insolvency laws provide for a “super” administrative priority, which ranks ahead of administrative creditors or a priority that ranks ahead of all creditors, including secured creditors (sometimes referred to as a “priming lien”). In countries where this latter type of priority is permitted, insolvency courts recognize the risk to the existing secured creditors and authorize these types of priority reluctantly and as a last resort. The granting of such a priority may be subject to certain conditions such as the provision of notice to affected secured creditors and the opportunity for them to be heard by the court; proof by the debtor that it is unable to obtain the necessary finance without the priority; and the provision of protection for any diminution of the economic value of encumbered assets, including by a sufficient excess in the value of the encumbered asset so that the existing secured creditor will not be exposed to an unreasonable risk that its position will be affected beyond that of the super priority. In some legal systems, all of these options for attracting post-commencement finance are available. As a general rule, the economic value of the rights of pre-existing secured creditors should be protected so that they will not be unreasonably harmed. If necessary (and as already discussed in relation to protection of the insolvency estate: see chapter II.B.8) this can be achieved by making periodic payments or providing security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending.

**4. Authorization for post-commencement finance**

251. It may be desirable to link the issue of authorization for new lending to the damage that may occur or the benefit that is likely to be provided as a result of the provision of new finance. A number of insolvency laws permit the insolvency representative to determine that new money is required for the continued operation or survival of the business or the preservation or enhancement of the value of the estate and provide that the insolvency representative (or a debtor-in-possession where that approach is followed) can obtain unsecured credit without approval by the court or by creditors, while other laws require approval by the court or creditors in certain circumstances. Given that new finance may be required on a fairly urgent basis to ensure the continuity of the business, it is desirable that the number of authorizations required be kept to a minimum, although clearly an insolvency law may take a

hierarchical approach, depending upon the security or priority to be provided. Although generally requiring court involvement may assist in promoting transparency and provide additional assurance to lenders, in many instances the insolvency representative may be in a better position to assess the need for new finance. In any event, the court generally will not have expertise or information additional to that provided by the insolvency representative on which to base its decision.

252. The question of providing security over unencumbered assets or assets that are not fully encumbered is not one that should generally require approval of the court. Where the insolvency law establishes the level of priority that generally can be given, for example, an administrative priority, court approval may not be required. Should court approval be considered desirable, an intermediate approach may be to establish a threshold above which approval of the court is required. However, where the security or priority to be given affects the interests, for example, of existing secured creditors and those secured creditors do not support what is proposed, approval of the court should be required. Where secured creditors consent to revised treatment of their security interests, approval of the court may not be required.

## 5. Effects of conversion

253. Some insolvency laws provide that any security provided in respect of new lending can be set aside in a subsequent liquidation, and may give rise to liability for delaying the commencement of liquidation and potentially damaging the interests of creditors. Such an approach has the potential to act as a disincentive to commence reorganization. A more desirable approach may be to provide that creditors obtaining priority for new funding will retain that priority in any subsequent liquidation. A further approach provides that the priority will be recognized in a subsequent liquidation, but will not necessarily be accorded the same level of priority and may rank, for example, after administrative claims relating to the costs of the liquidation or *pari passu* with administrative expenses.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions on post-commencement finance is to:

- (a) facilitate finance to be obtained for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the estate;
- (b) ensure appropriate protection for the providers of post-commencement finance;
- (c) ensure appropriate protection for those parties whose rights may be affected by the provision of post-commencement finance.

### Contents of legislative provisions

(49) The law should facilitate the insolvency representative obtaining post-commencement finance where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the

preservation or enhancement of the value of the assets of the estate. The law may require authorization by the court or creditors (or the creditor committee).

*Security for post-commencement finance*

(50) The law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on unencumbered assets, including after-acquired assets, or a junior or lower priority security interest on already encumbered assets of the estate.

(51) The law<sup>56</sup> should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation (52).

(52) The law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interest provided specified conditions are satisfied, including:

(a) the existing secured creditor was given the opportunity to be heard by the court;

(b) the debtor can prove that it cannot obtain the finance in any other way;

(c) the interests of the existing secured creditor will be protected,<sup>57</sup> including by a sufficient excess in the value of the encumbered asset so that the existing secured creditor will not be exposed to an unreasonable risk of harm.

*Priority for post-commencement finance*

(53) The law should establish the priority that may be accorded to post-commencement finance, ensuring at least the payment of the post-commencement finance provider ahead of ordinary unsecured creditors including those unsecured creditors with administrative priority.

*Effect of conversion on post-commencement finance*

(54) Where reorganization proceedings are converted to liquidation, the insolvency law should specify that any priority provided to post-commencement finance in the reorganization should continue to be recognized in the liquidation.<sup>58</sup>

## **E. Treatment of contracts**

### **1. Introduction**

254. As an economy develops, more and more of its wealth is likely to be contained in or controlled by contracts. As a result, the treatment of contracts is of overriding

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<sup>56</sup> This rule may be in a law other than the insolvency law, in which case the insolvency law should note the existence of the provision.

<sup>57</sup> See chapter II.B.8.

<sup>58</sup> The same order of priority may not necessarily be recognized. For example, post-commencement finance may rank in priority after administrative claims relating to the costs of the liquidation.

importance in insolvency. There are two overall difficulties in developing legal policies in that regard. The first difficulty is that, unlike all other assets of the insolvency estate, contracts usually are tied to liabilities or claims. That is, it is often the case that the estate must perform or pay in order to enjoy the rights that are potentially valuable assets. The result is that difficult decisions must be made about the treatment of a contract so as to produce the most value for the estate. A second difficulty is that contracts are of many different types. They include simple contracts for the sale of goods; short-term or long-term leases of land or of personal property; and immensely complicated contracts for franchises or for the construction and operation of major facilities, among many others. Additionally, the debtor could be involved in the contract as buyer or seller, lessor or lessee, licensor or licensee, provider or receiver and the problems presented in insolvency may be very different when viewed from different sides.

255. Achieving the objectives of maximizing the value of the estate and reducing liabilities and, in reorganization, enabling the debtor to survive and continue its affairs to the maximum extent possible in an uninterrupted manner may involve taking advantage of those contracts that are beneficial and contribute value to the estate (including contracts that will enable the continued use of crucial property that may be owned by a third party), and rejecting those that are burdensome, or those where the ongoing costs of performance exceed the benefit to be derived from the contract. As an example, in a contract where the debtor has agreed to purchase particular goods at a price which is half the market price at the time of the insolvency, obviously it would be advantageous to the insolvency representative to be able to continue to purchase at the lower price and sell at the market price. The counterparty would naturally like to get out of what is now an unprofitable agreement, but to require performance of the contract demands no more of the counterparty than that it observe the bargain it made prior to insolvency. In many systems it will not be permitted to escape performance of the contract, although it may be entitled to an assurance that it will be paid the contract price in full. In many examples, continuation of the contract will be beneficial to both contracting parties, not just to the debtor.

256. Deciding how contracts are to be treated in insolvency raises an initial question of the relative weight to be attached to upholding general contract law in insolvency on the one hand and the factors justifying interference with those established contractual principles on the other. A number of competing interests may need to be weighed to ensure an appropriate balance is achieved between general public policy goals, the goals of insolvency and the need for predictability in commercial relations. These interests include the relative importance of reorganization and the involvement of secured creditors in insolvency; particular social concerns raised by some types of contracts such as labour contracts (see below); the effect of permitting interference with the continuation of performance of contracts on commencement of insolvency proceedings, on the predictability of commercial and financial relations, and on the cost and availability of credit (the wider the powers to continue or reject contracts in insolvency, the higher the cost and the lower the availability of credit is likely to be); as well as the extent to which the powers to affect the performance of contracts will enhance the reuse of assets.

257. Where the insolvency law adopts the approach of permitting the performance of contracts to be affected in circumstances that may be contrary to general

contractual principles, further considerations are the extent of those powers and the types of contracts that can be affected. It is almost inevitable that at the commencement of insolvency proceedings, the debtor will be a party to at least one contract where both the debtor and the counterparty have remaining obligations to be performed other than the payment of money for goods delivered. No special rules are required for the situation where only one party has not fully performed its obligations. If it is the debtor that has not fully performed, the other party will have a claim for performance or damages which it can submit in the insolvency (see chapter V.A). If it is the counterparty that has not fully performed its obligations, the insolvency representative can demand performance or damages from that party. However, where both parties have not fully performed their obligations, it is a common feature of many insolvency laws that in defined circumstances, those contracts may be subject to the stay in a manner that prevents the counterparty from exercising a right of termination and they can be continued or rejected (or possibly assigned, although this is not widely permitted). Typically, the insolvency representative is charged with making this evaluation of how the contract should be treated. Jurisdictions differ, however, on the question of whether court approval is also required.

258. In reorganization, where the objective of the proceedings is to enable the debtor to survive and continue its affairs to the extent possible, the continuation of contracts that are beneficial or essential to the debtor's business and contribute value to the estate may be crucial to the success of the proceedings. These may include contracts for the supply of essential goods and services or contracts concerning the use of property crucial to the continued operation of the business, including property owned by third parties. Similarly, the prospects of success may be enhanced by allowing the insolvency representative to reject burdensome contracts, such as those contracts where the cost of performance is higher than the benefits to be received or, in the case, for example, of an unexpired lease, the contract rate exceeds the market rate. In liquidation, the desirability of contracts continuing after commencement of proceedings is likely to be less important than in reorganization, except where the contract may add value to the debtor's business or to a particular asset or promote the sale of the business as a going concern. A lease agreement, for example, where the rental is below market price and the remaining term is substantial, may prove central to any proposed sale of the business or may be sold to produce value for creditors.

259. As to the types of contracts to be affected, a common solution is for insolvency laws to provide general rules for all kinds of contracts and exceptions for certain special contracts. The ability to reject labour contracts, for example, may need to be limited in view of concerns that insolvency can be used as a means of expressly eliminating the protections that these contracts afford to employees. Other types of contracts requiring special treatment may include financial contracts (see chapter II.H), contracts for personal services, where the identity of the party to perform the agreement, whether the debtor itself or an employee of the debtor, is of particular importance, as well as contracts for loans and contracts for insurance.

## **2. Automatic termination clauses**

260. Many contracts include a clause that defines events of default giving the counterparty an unconditional right, for example, of termination or acceleration of

the contract (sometimes referred to as “ipso facto” clauses). These events of default commonly include the making of an application for commencement, or commencement, of insolvency proceedings; the appointment of an insolvency representative; the fact that the debtor satisfies the criteria for commencement of insolvency proceedings; and even indications that the debtor is in a weakened financial position. Some laws uphold the validity of these termination or acceleration clauses. In those cases where it is desirable that a contract continue to be performed after commencement of insolvency proceedings, this will only be possible if the counterparty does not elect, or can be persuaded not to elect, to exercise its rights under the contract or if the insolvency law includes a mechanism that can be used to persuade the counterparty to allow the contract to continue. Such a mechanism may include establishing a priority for payment for services provided after the commencement of proceedings (in some insolvency laws this may exist as a general provision which typically treats costs incurred after the commencement of proceedings as a first priority).

261. The approach of upholding these types of termination clauses may be supported by a number of factors including the desirability of respecting commercial bargains; the need to prevent the debtor from selectively performing contracts which are profitable and cancelling others (an advantage which is not available to the counterparty); the effect on financial contract netting of not upholding an automatic termination provision; the belief that since an insolvent business will generally be unable to pay, delaying the termination of contracts potentially only increases existing levels of debt; the need for creators of intellectual property to be able to control the use of that property; and the effect on the counterparty’s business of termination of a contract, especially one with respect to an intangible.

262. A different approach recognizes that a clause permitting termination or acceleration of a contract on the occurrence of a defined event of default, such as those noted above, is overridden by operation of the insolvency law, and the contract can be continued over the objection of the counterparty. In the first instance the counterparty’s right of termination will be subject to the stay, providing the insolvency representative with time to consider the contract and decide what action should be taken. Although the approach of overriding termination clauses can be regarded as interfering with general principles of contract law, nevertheless such interference may be crucial to the success of the proceedings. In reorganization, where, for example, the contract is a critical lease or involve the use of intellectual property embedded in a key product, continuing the contract may enhance the earnings potential of the business; reduce the bargaining power of an essential supplier; capture the value of the debtor’s contracts for the benefit of all creditors and assist in locking all creditors into a reorganization.

263. In liquidation, the arguments in favour of overriding termination clauses include the need to keep the business together to maximize its sale value or to enhance its earnings potential; to capture the value of the contract for the benefit of all creditors rather than forfeiting it to the counterparty; and the desirability of locking all parties into the final disposal of the business.

264. Although some insolvency laws do permit termination clauses to be overridden if insolvency proceedings are commenced, these clauses have not yet become a general feature of insolvency laws. There is an inherent tension between



promoting the debtor's survival, which may require the preservation of contracts, and injecting unpredictability and extra cost into commercial dealings by creating a variety of exceptions to general contract rules. While this issue clearly is one that may require a careful weighing of the advantages and disadvantages there are, nevertheless, circumstances where the ability of the insolvency representative to ensure that a contract continues will be crucial to the success of reorganization and also, but perhaps to a lesser extent, liquidation where the business is to be sold as a going concern. For these reasons, it is desirable that an insolvency law permit such clauses to be overridden. Any negative impact of a policy of overriding termination clauses can be balanced by providing compensation to creditors who can demonstrate that they have suffered damage or loss as a result of the contract continuing after commencement of insolvency proceedings, or including exceptions to a general override of automatic termination clauses for certain types of contracts, such as contracts to lend money and, in particular, financial contracts (see chapter II.H).

265. Where an insolvency law provides that termination clauses can be overridden, creditors may be tempted to take pre-emptive action to avoid that outcome by terminating the contract on some other ground before the application for insolvency proceedings is made (assuming a default by the debtor other than one triggered by commencement of the proceedings). Such a result may be mitigated by providing that the insolvency representative has the power to reinstate those contracts, provided both pre- and post-commencement obligations are fulfilled.

### **3. Continuation or rejection of contracts**

#### **(a) Procedure for continuation or rejection of contracts**

266. Insolvency laws adopt different approaches to continuation and rejection of contracts. Under some laws, contracts are unaffected by the commencement of insolvency proceedings so that contractual obligations remain binding and the general rules of contract law will continue to apply unless the insolvency law expressly provides for different rules, such as an express power to override automatic termination clauses (see above) or to reject a contract.

267. Other laws link continuation and rejection in a common procedure which requires the insolvency representative to take some positive action with respect to a contract, such as providing notice to the counterparty that the contract is to continue (and in some cases be adopted by the insolvency estate) or be rejected. Under laws that adopt this approach, the stay should apply to the counterparty's right to terminate, allowing the insolvency representative time to consider what action should be taken with respect to the contract (see chapter II.B). One disadvantage of the approach of requiring the insolvency representative to take positive action on all contracts is that in practice there may be many cases where no decision as to the contract can be taken because the contract cannot be performed. To require an explicit choice to be made on every contract also could be excessively costly and cumbersome. A further difficulty associated with this approach relates to whether or not the insolvency representative is well informed of all contracts to which the debtor is a party, and is therefore in a position to take action with respect to each one. The manner in which the law deals with contracts of which the insolvency representative is not aware, particularly in terms of default rules, is therefore important.

(i) *Specifying time periods*

268. Some laws requiring a positive action also require that action to be taken within a specified period of time (with perhaps provision for extension in certain circumstances), which would generally be longer in reorganization than in liquidation. Examples of specific time periods vary from 28 to 60 days. Other laws provide for the time period to be determined by the court. This approach is aimed at ensuring certainty for both parties. It requires the insolvency representative to take timely action with respect to contracts outstanding at the time of commencement and offers the counterparty some certainty as to the continued performance of the contract within a reasonable period after commencement of proceedings.

(ii) *Default rules*

269. A number of laws adopt a default rule to the effect that failure of the insolvency representative to act within the specified time results in the contract being treated, for example, as rejected or unenforceable. Where a default rule is adopted, a distinction between liquidation and reorganization might be made, as well as a distinction between those contracts of which the insolvency representative is aware and those of which it is not aware. In liquidation, since it may be reasonable to assume that the failure of the insolvency representative to take a decision with respect to a contract would most likely imply a decision to reject, contracts could be automatically rejected unless action is taken to preserve a contract. That result would be consistent with the goal of liquidation where it requires piecemeal sale of the assets.

270. The same assumption may not always be appropriate in reorganization or sale of the business as a going concern and more flexibility might be required to avoid a situation where the failure to take a timely decision deprives the estate of a contract that might be crucial for the proceedings. Accordingly, it may be appropriate to allow the insolvency representative to make a decision as to rejection up to the time of approval of the reorganization plan, provided that any benefit received under the contract is paid for up to the time of rejection as an administrative expense and that the counterparty has the ability to compel an earlier decision where it is required or desired. It is desirable that treatment of specific contracts is addressed clearly in the plan, with perhaps a provision that contracts not so addressed should be treated as automatically rejected on approval of the plan.

(iii) *Right of counterparty to demand a decision*

271. Some laws provide that the counterparty has an unconditional right to request the insolvency representative to make a decision on a particular contract within a specified period of time. Such a rule may apply even where the insolvency law specifies a time limit for the insolvency representative to make a decision as it will enable the counterparty to seek a decision without having to wait for the time limit to expire. This may be of particular importance where the contract in question involves provision of an ongoing service, and failure by the insolvency representative to act may lead to the accrual of unnecessary expense (e.g. rent for property which is leased by the debtor can be a significant administrative cost if a lease is not promptly terminated), or to the provision of an essential service being terminated (where the insolvency representative is required to promptly decide that a contract should continue). Where no decision is made by the insolvency

representative within the specified time period, the insolvency law may either permit the counterparty to apply to the court to require a decision to be made or apply a default rule that the contract be treated either as continued or rejected.

(iv) *Continuation of contract as a whole*

272. Whatever rules are adopted with respect to the continuation and rejection of contracts, it is desirable that any rights of the insolvency representative should be limited to the contract as a whole, thus avoiding a situation where the insolvency representative could choose to continue or adopt certain parts of a contract and reject others.

(v) *Contracts known to the insolvency representative*

273. It is also desirable that the insolvency representative's power with respect to contracts is limited to those contracts that are known to it or the court (where the insolvency law requires the court to make determinations with respect to contracts). If this limitation is not adopted, the consequences of failure to take a decision with respect to a contract, the existence of which is not known to the insolvency representative, might lead to claims for damages and possible professional liability. Where the insolvency representative is not aware of a particular contract, it also may be undesirable for the law to apply a default rule that will lead to continuation or rejection before the insolvency representative has had the opportunity to assess the contract. One solution to this issue (to the extent that the debtor complies) would be to include in the law a requirement for the debtor to provide to the insolvency representative a list of contracts that have not been fully performed (see chapter III.A.4(b)).

**(b) Timing and notice of continuation and rejection**

274. Where the law permits the insolvency representative to reject a contract, it will be desirable to establish the time from which the rejection will be effective, whether from the time of making the decision or retroactively. One approach is to make rejection retroactive to the time of application, with the result that no post-application liability will arise under a contract, except in respect of post-application goods or services supplied to the benefit of the estate.

275. Where the law provides for the insolvency representative to take a decision as to continuation or rejection of a contract, it is desirable that it also include a requirement for the giving of notice of that decision to the counterparty or counterparties. The notice should inform the counterparty of its rights, including to challenge the insolvency representative's decision with respect to the contract and to submit a claim in the insolvency (either with respect to a pre-commencement default or arising from the decision on the contract), including the relevant formalities.

**(c) Continuation of contracts where the debtor is in default**

276. Where the debtor is in default under a contract at the time of the application for insolvency, there is a policy issue of whether it is fair to require the counterparty to continue to deal with an insolvent debtor in these circumstances. Some insolvency laws require, as a condition of continuing the performance of such a contract for the remainder of the contract term, that the insolvency representative

cure any defaults by the debtor under the contract (returning the counterparty to the economic position it was in before the default occurred) and guarantee future performance by providing, for example, a bond or guarantee. Other insolvency laws do not require past defaults to be cured, but may impose restrictions as to the circumstances in which performance can be continued, for example, contracts which can be divided into severable units, such as contracts for the supply of utilities, which are billed on a monthly basis. Insolvency laws often specifically allow the continuation of these contracts for the provision of essential services, which may include telephone, electricity, gas, water and waste collection. There is some justification for assuring the debtor access to those services without requiring cure of the default, especially in the case of a creditor application for commencement and, on the basis that the debtor could perform its post-commencement obligations, providing for the continuation of the service. The insolvency representative may be required to guarantee future performance and in some cases accept personal liability in the event of future default.

**(d) Effect of continuation or rejection on the counterparty**

*(i) Continuation*

277. Where a contract continues to be performed after commencement of insolvency proceedings, pending a decision as to how that contract is to be treated, it is desirable that the insolvency estate be required to pay for the post-commencement performance of the contract, particularly where the contract is ultimately rejected. The rationale for such an approach is that it is fair to assume that post-commencement performance of a contract or continued use of a third party asset is of benefit to the estate, or otherwise the insolvency representative would have rejected the contract.

278. Although it is not common for insolvency laws to do so, it may also be desirable to address the question of the obligations of the counterparty in the period between commencement of proceedings and a decision as to treatment of a particular contract (in those cases where such a decision is required), and in particular whether the counterparty is required to commence or continue its performance. Such an approach would satisfy objectives of certainty and predictability for all parties concerned.

279. Under those laws that require a positive action by the insolvency representative, contracts that the insolvency representative elects to continue to perform after commencement are treated as ongoing post-commencement obligations of the debtor that must be performed both by the estate and the counterparty. Claims arising from performance of these contract are treated in a number of insolvency laws as an administrative expense (see chapter V.A) (not as an unsecured claim) and given priority in distribution. Since the granting of such a priority constitutes a potential risk for other creditors (who will be paid after the priority creditors), it is desirable if this approach is followed, that only contracts that will be profitable or essential to the continued operation of the debtor continue after commencement of insolvency proceedings. In those jurisdictions where the general rules of contract law will apply and no decision as to continuation is required from the insolvency representative, the insolvency law may provide that such claims will have no priority and be ranked with other unsecured claims.

280. Since continuation of a contract with a party subject to insolvency proceedings may involve an element of risk for the counterparty that would not otherwise have arisen, such as non-payment, it may be appropriate for the insolvency law to consider whether certain measures of protection should be afforded the counterparty. A number of factors will need to be weighed, including the importance of the contract to the proceedings; the cost to the proceedings of providing the necessary protections; whether the debtor or the estate will be able to actually perform the obligations under the continued contract; and the impact on commercial contracting of forcing the counterparty to assume the risk of non-payment. If the contract provides, for example, for the seller to extend credit to the debtor for a certain period of time before requiring payment, or provides for payment on delivery, the seller may incur substantial costs and suffer harm if by the time of the payment or the delivery the insolvency representative is no longer able to pay. Some laws address these issues by requiring the insolvency representative to guarantee payment or performance to the counterparty, such as through a bank guarantee or letter of credit. Under other laws, the insolvency representative may be personally liable for performance, an approach that may have the potential to discourage continuation of contracts where there is some risk of failure and thus affect the reorganization. Personal liability may be particularly onerous in the case of contracts such as labour contracts. Under a further approach, the counterparty is required to assume the risk of non-payment on the basis that that risk is a usual risk of commercial dealings. Providing an administrative priority for claims and payments relating to post-commencement performance under a continued contract may afford a measure of protection to the counterparty (although it may be limited if assets available for the payment of such expenses are limited).

(ii) *Rejection*

281. Where a contract is rejected, the counterparty is generally excused from performing the remainder of the contract and the principal issue to be determined is the remedies that will be available to the counterparty. Many laws provide that the counterparty is only entitled to a remedy in damages, even if other remedies would have been available outside of insolvency. One of the reasons for this approach is that allowing other remedies, such as delivery of goods manufactured but not delivered prior to commencement of insolvency proceedings, would amount to paying the full claim of the counterparty, a result not available to other unsecured creditors and one which represents a departure from the principle of equal treatment. Some laws however do permit such a remedy in respect of the delivery of goods, while other laws permit performance in the case of contracts for the sale of land.

282. Where the remedy is one of damages, calculation of the unsecured damages that result from the rejection might be determined in accordance with applicable general law and the counterparty becomes an unsecured creditor with a claim equal to the determined amount. In addition to damages resulting from the rejection, the counterparty may have a claim with respect to performance of the contract in the period before rejection (which may rank as an administrative claim).<sup>59</sup>

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<sup>59</sup> See chapter V.C on ranking of claims.

(e) **Amendment of continuing contracts**

283. A further issue to be considered in respect of continued contracts is the circumstances in which an insolvency representative may alter the terms and conditions of those contracts. As noted above, the terms and conditions of the contract must be respected and, as a general principle, the insolvency representative will have no greater rights in respect of amendment of the contract than the debtor itself would normally have under the contract. The insolvency representative generally would be required to negotiate any amendment with the counterparty, and any modification without the consent of that other party will constitute a breach of contract for which the counterparty may claim damages.

**4. Leases of land and premises**

284. Some insolvency laws include specific provisions on unexpired leases of land and premises, distinguishing between residential and commercial leases. Commercial leases in particular are often of significance in reorganization cases. For example, leases at below market price represent an asset that might be sold and return a benefit to the estate. The ability to escape a lease of a money-losing location may be an advantage where the debtor needs to reduce the size of its business to ensure the success of reorganization.

285. Under some laws, a lease of which the debtor is the lessee can be rejected without reference to the expiry date, provided the notice periods in the law or the lease are observed. Rejection would give rise to a claim by the lessor for compensation for premature termination. Where the debtor is a lessee and its lease is to continue, it may be appropriate for certain conditions to be imposed on the insolvency estate, such as that the insolvency representative must cure any default, provide compensation for any harm arising from such a default and provide assurance as to future performance under the lease. It may also be desirable to set a ceiling on damages claimed by the lessor (which may be a monetary amount or a specified period of time in respect of which damages may be payable) so that the claim under a long-term lease does not overwhelm the claims of other creditors. Lessors ordinarily will have the opportunity to mitigate losses by re-letting the property.

**5. Assignment**

286. The ability of the insolvency representative to elect to assign a contract notwithstanding insolvency-triggered termination provisions or restrictions on transfer contained in the contract can have significant benefits to the estate, and therefore to the beneficiaries of the proceeds of distribution following liquidation or as part of a reorganization. There may be circumstances, such as where the contract price is lower than the market value, where rejection of the contract may result in a windfall for the counterparty. If the contract can be assigned, the insolvency estate rather than the counterparty will benefit from the difference between the contract and market prices.

287. However, providing for assignment of a contract against the terms of the contract may undermine the contractual rights of the counterparty and raise issues of prejudice, especially where the counterparty has little or no say in the selection of the assignee. It may also be undesirable to compel the transfer of a contract to a transferee who may not be known to the counterparty or with whom the counterparty may not wish to do

business. Different approaches are taken to the issue of assignment. Some insolvency laws specify that non-assignment clauses are made null and void by the commencement of insolvency proceedings. Other insolvency laws leave the matter to general contract law; if the contract contains a non-assignment clause then the contract cannot be assigned unless the counterparty or of all parties to the original contract agree. Some of these laws also provide that if the counterparty does not consent to assignment, the court may approve the assignment if certain conditions are met, for example, it can be shown that the counterparty is withholding consent unreasonably, if the counterparty will not be substantially disadvantaged by the assignment, or if the insolvency representative can demonstrate to the counterparty that the assignee can adequately perform the contract. The insolvency representative is then free to assign the contract for the benefit of the estate.<sup>60</sup>

288. Where an insolvency law allows assignment of contracts, it would be highly desirable to also require the debtor to cure any defaults prior to the assignment of a contract. This would help ensure a successful problem-free substitution of the assignee for the debtor as the contracting party.

289. Irrespective of the powers of the insolvency representative to assign contracts, some contracts cannot be assigned because they require the performance of irreplaceable personal services or because assignment is prevented by the operation of law. Some countries, for example, prevent the assignment of government procurement contracts.

## **6. General exceptions to the power to continue, reject and assign contracts**

290. Exceptions to the powers of the insolvency representative with respect to treatment of contracts generally fall into two categories. In respect of the first, where the insolvency representative has the power to override automatic termination provisions, specific exceptions may be desirable for contracts such as short-term financial contracts (e.g. swap and futures contracts—see chapter II.H). Other contracts in this category might include insurance contracts and contracts for the making of a loan. Limitations to the power to reject may also be appropriate in the case of labour agreements and agreements where the debtor is a lessor or franchisor, or a licensor of intellectual property and termination of the agreement would end or seriously affect the business of the counterparty, particularly where the advantage to the debtor may be relatively minor. Limitations may also apply in the case of contracts with government, such as licensing agreements and procurement contracts.

### **(a) Labour contracts**

291. As noted above, one important exception to the powers discussed in this section is that of labour contracts. Although particularly relevant to reorganization, such contracts are also relevant in liquidation where the insolvency representative is attempting to sell the debtor's business as a going concern. A higher price may be obtained if the insolvency representative is able to terminate onerous labour contracts or to achieve necessary downsizing of the labour force of the debtor. However, the relationship between employee and employer raises some of the most difficult questions in insolvency law. It is not simply the contract itself, which in essence is a

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<sup>60</sup> This approach is consistent, for example, with the approach taken in the UNCITRAL Convention on the Assignment of Receivables in International Trade (2001), article 9.

pending contract like any other contract, but also the usually mandatory provisions of other laws that protect the position of employees. These may relate, for example, to unfair dismissal; minimum rates of pay; paid leave; maximum work periods; maternity leave; equal treatment and non-discrimination. The difficult question is generally the extent to which these provisions will impact upon the insolvency, raising issues that are much broader than termination of the contract and priority of monetary claims in respect of unpaid wages and benefits (see chapter V.A and C). For these reasons, a number of countries have adopted special regimes to deal with the protection of employees' claims in insolvency and, in order to avoid insolvency proceedings being used as a means of eliminating employee protection, these laws specifically limit the insolvency representative's ability to reject labour contracts. This approach may include limiting the use of the powers to certain specified circumstances, for example, where the employee's remuneration is excessive in comparison to what the average employee would receive for the same work. In some countries the law provides for employees to follow the business in case of sale as a going concern in both liquidation and reorganization, in others only in reorganization.

**(b) Contracts for irreplaceable and personal services**

292. Another category relates to those contracts where, irrespective of how the insolvency law treats automatic termination provisions, the contract cannot continue because it provides for performance by the debtor or an employee of the debtor of irreplaceable personal services (the contract may involve, for example, particular intellectual property, services involving a partnership agreement, provision of services by a person with highly specialised skills, or by a named person with a particular skill).

293. To enhance the transparency of the insolvency regime, it is desirable that the limitations on the powers of the insolvency representative to deal with the types of contracts discussed in this section are stated clearly in the insolvency law.

**7. Post-commencement contracts**

294. A further category of contracts in insolvency, in addition to contracts that are not fully performed, is contracts entered into after the proceedings have commenced. In reorganization and where the business is to be sold as a going concern in liquidation, there will often be a need for contracts to be entered into (both in the ordinary course of business and otherwise) to maintain the business as a going concern and enable it to continue earning for the ultimate benefit of creditors. These contracts are generally regarded as post-commencement obligations of the estate and costs and expenses incurred in their performance are paid in full as an expense of the insolvency administration (see chapter V.C).

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on treatment of contracts is to:

(a) establish the manner in which contracts, under which both the debtor and its counterparty have not yet fully performed their respective obligations, should be addressed in the law, including the relationship between the law and applicable



general law, with the objective of maximizing the value and reducing the liabilities of the estate;

(b) define the scope of the powers to deal with these contracts and the situations in which and by whom these powers may be exercised;

(c) identify the types of contracts that should be excluded from the exercise of these powers;

(d) identify the kinds of protection that will be available to counterparties to continued contracts.

### **Contents of legislative provisions**

(55) The law should specify the treatment of contracts under which both the debtor and its counterparty have not yet fully performed their respective obligations.

#### *Automatic termination clauses*

(56) The law should specify that, on the commencement of insolvency proceedings, any contract clause that automatically terminates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

(a) an application for commencement, or commencement, of insolvency proceedings;

(b) the appointment of an insolvency representative.<sup>61</sup>

(57) The law should specify the contracts that are exempt from the operation of recommendation (56), such as financial contracts, or subject to special rules, such as labour contracts.

#### *Continuation or rejection*

(58) The law should specify that the insolvency representative may decide to continue the performance of a contract of which it is aware where continuation would be beneficial to the insolvency estate.<sup>62</sup> The law should specify that the right to continue applies to the contract as a whole and that the effect of continuation is that all terms of the contract are enforceable.

(59) The law may permit the insolvency representative to decide to reject a contract.<sup>63</sup> The law should specify that the right to reject applies to the contract as a whole.

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<sup>61</sup> This recommendation would apply only to those contracts where such clauses could be overridden (see commentary at chapter II.E.6 on exceptions) and is not intended to be exclusive, but to establish a minimum: the court should be able to examine other contractual clauses that would have the effect of terminating a contract on the occurrence of similar events.

<sup>62</sup> Provided the automatic stay on commencement of proceedings applies to prevent termination (pursuant to an automatic termination clause) of contracts with the debtor, all contracts should remain in place to enable the insolvency representative to consider the possibility of continuation, unless the contract has a termination date which happens to fall after the commencement of insolvency proceedings.

<sup>63</sup> An alternative to providing a power to reject contracts is the approach of those jurisdictions that provide that performance of a contract simply ceases unless the insolvency representative decides to continue its performance.

*Timing and notice of decision to continue or reject*

(60) The law should specify a time period within which the insolvency representative is required to make a decision to continue or reject a contract, which time period may be extended by the court.

(61) The law should specify the time at which the rejection will be effective.

(62) Where a contract is continued or rejected, the law should specify that the counterparty be given notice of the continuation or rejection, including its rights in respect to submitting a claim (in particular the time in which the claim should be submitted), and permit the counterparty to object to that decision [in the court].

*Counterparty's right to request a decision*

(63) Notwithstanding recommendation (60), the law should permit a counterparty to request the insolvency representative (within any specified time limit) to make a prompt decision and, in the event that the insolvency representative fails to act, to request the court to direct the insolvency representative to make a decision to continue or reject a contract.

*Consequences of failure to make a decision*

(64) The law should specify the consequences of the failure of the insolvency representative to make a decision within the specified time period with respect to contracts of which it is aware. Failure by the insolvency representative to act within the specified time period should not operate to continue a contract of which the insolvency representative was not aware.<sup>64</sup>

*Continuation of contracts where the debtor is in breach*

(65)(a) The law should specify that where the debtor is in breach under a contract the insolvency representative can continue the performance of that contract, provided the breach is cured, the non-breaching counterparty is substantially returned to the economic position it was in before the breach, and the estate is able to perform under the continued contract.

(b) The law should specify that where the debtor is in breach under a contract for the provision of essential services,<sup>65</sup> the continued provision of those services to the debtor should be assured, without requiring cure of the default, provided the estate is able to perform under the continued contract.

*Claims associated with continued or rejected contracts*

(66) The law should specify that where a decision is made to continue performance of a contract, damages for the subsequent breach of that contract should be payable as an administrative expense.

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<sup>64</sup> See chapter III.A.4(b) which refers to the debtor's obligation to provide information, including a list of contracts not fully performed.

<sup>65</sup> Essential services might include telephone, gas, water, electricity, waste collection: see chapter II.E.3(c).

(67) In the period after the commencement of insolvency proceedings, and before a contract is rejected, the law should specify:

(a) that if the counterparty has performed the contract to the benefit of the estate, the benefits conferred upon the estate, pursuant to the terms of the contract, are payable as an administrative expense.<sup>66</sup>

(b) that if the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against erosion of the value of those assets and the benefit conferred on the estate by the use of those assets should be treated in accordance with paragraph (a).

(68) The law should specify that any damage arising from the rejection of a pre-commencement contract would be determined in accordance with applicable general law and should be treated as an ordinary unsecured claim. Claims relating to the rejection of a long-term contract may be limited by the law.

#### *Assignment of contracts*

(69) The law may specify that the insolvency representative can decide to assign a contract, notwithstanding restrictions in the contract, provided the assignment would be beneficial to the estate.

(70) Where the counterparty objects to assignment of a contract, the law may permit the court to nonetheless approve the assignment provided:

- (a) the insolvency representative continues the contract;
- (b) the assignee can perform the assigned contractual obligations;
- (c) the counterparty is not substantially disadvantaged by the assignment.

(71) The law may specify that where the contract is assigned, the assignee will be substituted for the debtor as the contracting party with effect from the date of the assignment.

#### *Post-commencement contracts*

(72) The law should specify that contracts entered into after the commencement of insolvency proceedings are post-commencement obligations of the estate. Claims arising from those contracts should be payable as an administrative expense.

## **F. Avoidance proceedings**

### **1. Introduction**

295. Insolvency proceedings (both liquidation and reorganization) may commence at lengthy periods after a debtor first becomes aware that such an outcome cannot be avoided. In that intervening period, there may be significant opportunities for the debtor to attempt to hide assets from creditors, incur artificial liabilities, make donations or gifts to relatives and friends, or pay certain creditors to the exclusion of others. There may also be opportunities for creditors to initiate strategic action to

place themselves in an advantageous position. The result of such activities, in terms of the eventual insolvency proceedings, is to generally disadvantage ordinary unsecured creditors who were not party to such actions and do not have the protection of security.

296. The use of the word “transaction” in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security interest, a guarantee, a loan or a release, and may include a composite series of these transactions.

297. Many insolvency laws include provisions which apply retroactively from a particular date (such as the application for, or commencement of, insolvency proceedings) for a specified period of time (often referred to as the suspect period) and are designed to overturn those past transactions to which the insolvent debtor was a party or which involved the debtor’s property where they have certain effects. These effects include reducing the net worth of the debtor (for example, by gifting of its assets, or transferring or selling assets for less than their fair commercial value); or upsetting the principle of equal sharing between creditors of the same rank (for example, by payment of a debt to a particular unsecured creditor or granting a security to a creditor who is otherwise unsecured when other unsecured creditors remain unpaid and unsecured). Many non-insolvency laws also address these types of transactions as being detrimental to creditors outside of insolvency. In some cases, the insolvency representative will be able to use those non-insolvency laws in addition to the provisions of the insolvency law.

298. It is a generally accepted principle of insolvency law that collective action is more efficient in maximising the assets available to creditors than a system that leaves creditors free to pursue their individual remedies and that collective action requires all like creditors be treated alike. Provisions dealing with avoidance powers are designed to support those collective goals, ensuring that creditors receive a fair allocation of an insolvent debtor’s assets consistent with established priorities for payment and preserving the integrity of the insolvency estate. Avoidance provisions may also have a deterrent effect, discouraging creditors from pursuing individual remedies in the period leading up to insolvency if they know that these may be reversed or their effects nullified on commencement. For these reasons, transactions typically are made avoidable in insolvency to prevent fraud (for example, transactions designed to hide assets for the later benefit of the debtor or to benefit the officers, owners or directors of the debtor); to uphold the general enforcement of creditors’ rights; to ensure equitable treatment of all creditors by preventing favouritism where the debtor wishes to advantage certain creditors at the expense of the rest; to prevent a sudden loss of value from the business entity just before the supervision of the insolvency proceedings is imposed; and, in some countries, to create a framework for encouraging out-of-court settlement—creditors will know that last-minute transactions or seizures of assets can be set aside and therefore will be more likely to work with debtors to arrive at workable settlements without court intervention.

299. Notwithstanding the rationale of avoidance provisions, it is important to bear in mind that many of the transactions that may be subject to avoidance are perfectly normal and acceptable when they occur outside an insolvency context, but become

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<sup>66</sup> See chapter V.C.

suspect only when they occur in proximity to the commencement of insolvency proceedings. Avoidance powers are not intended to replace or otherwise affect other devices for the protection of the interests of creditors that would be available under general civil or commercial law.

300. Avoidance rules are much discussed, principally as to their effectiveness in practice and the somewhat arbitrary rules that are necessary to define, for example, relevant time periods and the nature of the transactions that may be avoided. Nevertheless, avoidance provisions can be important to an insolvency law not only because the policy upon which they are based is sound, but also because they may result in recovery of assets or their value for the benefit of creditors generally, and because provisions of this nature help to create a code of fair commercial conduct that is part of appropriate standards for the governance of commercial entities. It should be noted that in the cross-border context, jurisdictions with insolvency laws which do not provide that certain types of transactions are subject to avoidance, may encounter difficulties with recognition of proceedings and cooperation with courts and insolvency officials of jurisdictions where those transactions are subject to avoidance.

301. As is the case with a number of the core provisions of an insolvency law, the design of avoidance provisions requires a balance to be reached between competing social benefits such as, on the one hand, the need for strong powers to maximize the value of the estate for the benefit of all creditors and on the other hand, the possible undermining of contractual predictability and certainty. It may also require a balance to be reached between avoidance criteria that are easily proven and will result in a number of transactions being avoided and narrower avoidance criteria that are difficult to prove but more restricted in the number of transactions that will successfully be avoided. To minimize the potentially negative effects of avoidance powers on contractual predictability and certainty, it is desirable that as far as possible the categories of transactions to be avoidable (irrespective of whether they are broadly or narrowly defined), and the exercise of avoidance powers be subject to clear criteria that will enable business and commercial risks to be ascertained.

302. The decision whether or not to commence avoidance proceedings requires a number of different considerations to be weighed. These will generally relate to cost and likely benefit; in the case of actions to restore assets to the insolvency estate, they will include whether avoidance of the transaction will be beneficial to the estate or detrimental (such as where the taking of an avoidance action may disrupt reorganization proposals, especially where the action can be taken by creditors without the consent of the insolvency representative); the likely cost to the estate; the likelihood of recovering value for the estate; possible delays in recovery; and the difficulties associated with proving the elements necessary to avoid a particular transaction.

## **2. Avoidance criteria**

303. Approaches to establishing the criteria for avoidance actions vary considerably among insolvency laws in terms of specific criteria and how they are combined in each law. In terms of the applicable criteria, they can be grouped broadly as objective and subjective criteria.

**(a) Objective criteria**

304. One approach emphasizes the reliance on generalized, objective criteria for determining whether transactions are avoidable. The question would be, for example, whether the transaction took place within the suspect period or whether the transaction evidenced any of a number of general characteristics set forth in the law (e.g. whether appropriate value was given for the assets transferred or the obligation incurred, whether the debt was mature or the obligation due, or whether there was a special relationship between the parties to the transaction). While such generalized criteria may be easier to apply than criteria that rely upon proof, for example, of intent, they can also have arbitrary results if relied upon exclusively. So, for example, legitimate and useful transactions that fall within the specified period might be avoided, while fraudulent or preferential transactions that fall outside the period are protected.

**(b) Subjective criteria**

305. Another approach emphasizes case-specific, subjective criteria such as whether there is evidence of intention to hide assets from creditors, whether the debtor was insolvent when the transaction took place or became insolvent as a result of the transaction, whether the transaction was unfair in relation to certain creditors and whether the counterparty knew that the debtor was insolvent at the time the transaction took place or would become insolvent as a result of the transaction. This individualized approach may require detailed consideration of the intent of the parties to the transaction and of other factors such as the debtor's financial circumstances at the time the transaction occurred, the financial effect of the transaction on the debtor's assets and what might constitute the normal course of business between the debtor and particular creditors.

**(c) Combining the elements**

306. Very few insolvency laws rely solely on subjective criteria as the basis of avoidance provisions; they are generally combined with time periods within which the transactions must have occurred. In some countries a heavy reliance upon subjective criteria has led to considerable litigation and imposition of extensive costs on insolvency estates. In order to avoid these costs, some laws recently have adopted a strictly objective approach of a short suspect period, such as three to four months, which in some cases is combined with an arbitrary rule that all transactions occurring within that period would be suspect unless there was a roughly contemporaneous exchange of value between the parties to the transaction. Additionally the short suspect period may be used to create a presumption of necessary intent or knowledge, especially of insolvency, on the part of the debtor or the person receiving the transfer or both. Some laws adopt a two-tiered approach combining the short period within which all transactions are avoided, with a longer period in which certain additional elements have to be proven. So for example, the law may specify that a certain type of transaction occurring within, for example, a six month period of commencement, is avoided without requiring the insolvency representative to show anything other than that it is a transaction as defined for the purposes of the legislation and that it occurred within the time limit, and no defences are available to the counterparty. For transactions occurring within, for example, a one year period, the insolvency representative is required to show that

the transaction was not in the ordinary course of business and that it had, for example, a preferential effect. To defeat the claim the counterparty must show that it has a relevant defence.

307. A number of insolvency laws also combine these different approaches to address different types of transactions. For example, preferential transactions and undervalued transactions may be defined by reference to objective criteria, while transactions aimed at defeating or hindering creditors will be defined by reference to the more subjective elements involving questions of intent of both the debtor and the counterparty. One insolvency law that adopts a combination of those elements provides, for example, that transactions such as gifts, security for existing debts and extraordinary payments (those that have not been made with the usual means of payment or before the due time) can be avoided where they are made within three months prior to commencement. Other transactions can be set aside if the debtor was insolvent at the time of the transaction, the transaction was unfair or improper in relation to a group of creditors and the counterparty knew that the debtor was insolvent at the time the transaction occurred.

**(d) Ordinary course of business**

308. Of special note, many insolvency laws use the concept of the “ordinary course of business” in defining their avoidance criteria, so that an extraordinary payment, as noted above, may be subject to avoidance. The concept has wider relevance to an insolvency regime as it may also be used, for example, to draw a distinction between the exercise of powers regarding the use and disposition of assets during the insolvency proceedings in the “ordinary course of business” and in other circumstances, both in terms of who may exercise such powers, and the protections that are required.

309. States define the “ordinary course of business” with a varying emphasis on different elements. A common purpose of the definition in most jurisdictions, however, is to allow a business to have made or continue making routine payments as it trades, without subjecting such transactions to possible avoidance. Such permitted payments might include the payment of rent, utilities such as electricity and telephone, and possibly also payment for trade supplies.

310. Some laws focus on the prior conduct of the parties, especially regarding the method, quantity and regularity of supply or payment. In such a case, any variation from contract, custom or what may be deemed to be regular practice between the parties, e.g. a payment by abnormal means will be regarded as being outside the “ordinary course of business”. Another approach is to focus on the intention of one or both of the parties, by asking whether the creditor had knowledge, or ought to have had knowledge, of the debtors financial state, or that the debtor intended to prefer one creditor over others.

311. A further approach is to apply standards based upon usual industry, or even general commercial practice to the terms of the transaction and the circumstances in which it was entered into. Other laws regard any payment exceeding a certain percentage of the value of the debtor’s assets as extraordinary.

312. It is important that a test for the “ordinary course of business” balance flexibility, so as to not unduly restrict new developments in commercial practice, with an overriding requirement for certainty.

(e) **Defences**

313. Where an insolvency law provides defences to avoidance provisions for individual counterparties, those defences may have the potential to dilute the efficacy of the principal purpose of the provisions. Defences that involve elements that may be subject to dispute, such as that the transaction occurred in the ordinary course of business or that the counterparty acted in good faith can create uncertainty for all parties and may require determination by the court. The likelihood of such uncertainty occurring will be bolstered by the courts adopting a wide interpretation of these defences in favour of counterparties, and by the consequent inability or reluctance of the insolvency representative to use avoidance provisions as an effective tool in an insolvency, whether because of associated costs or because the procedures are inefficient and unpredictable. These potential difficulties underscore the desirability of an insolvency law adopting clear and predictable avoidance criteria and defences that will enable all parties to assess potential risks and avoid disputes, for example objective criteria focussing on the effect or result of transactions rather than on the intent of the parties. Where elements such as “ordinary course of business” are included they should be clearly defined and circumscribed by the insolvency law.

**3. Types of transactions subject to avoidance**

314. Although variously defined, there are three broadly common types of avoidable transactions that are found in most legal systems and are used in this Guide as the basis for discussion. They are: transactions intended to defeat, hinder or delay creditors from collecting their claims, transactions at an undervalue, and transactions with certain creditors which could be regarded as preferential. Some transactions may have the characteristics of more than one of these different classes, depending upon the individual circumstances of each transaction. For example, transactions which appear to be preferential may be more in the character of transactions intended to defeat, hinder or delay creditors when the purpose of the transaction is to put assets beyond the reach of a creditor or potential creditor or to otherwise prejudice the interests of that creditor and the transaction occurs when the debtor will be unable to pay its debts as they become due or where they leave the debtor with insufficient assets to conduct its business. Similarly, transactions at an undervalue may also be preferential when they involve creditors, but not when they involve third parties, and where there is a clear intent to hinder, defeat or delay creditors, they will fall into the first category of transactions. In cases such as these, the insolvency representative may be able to choose the category under which a particular transaction is to be avoided and thus take advantage of the variations in requirements of proof and suspect periods that typically apply.

315. To achieve as much clarity and certainty as possible and avoid unnecessary overlap, it is desirable that in determining the categories of transaction to be subject to avoidance provisions, an insolvency law specifies the particular characteristics of a transaction (including the effect of the transaction) that are essential for it to be avoided, rather than relying on broader labels, such as “fraudulent” or “preferential”.

(a) **Transactions intended to defeat, hinder or delay creditors**

316. These types of transactions involve the debtor transferring assets to any third party with the intention of putting them beyond the reach of creditors, and generally



require that the third party knew or should have known, of the debtor's intent in effecting such a transfer. Such transfers will generally disadvantage all unsecured creditors. These transactions generally cannot be avoided automatically by reference to an objective test of a fixed period of time in which the transactions occurred because of the need to prove the intent of the debtor. That intent is rarely proven by direct evidence, but rather by identifying circumstances that are common to these types of transactions. Although these circumstances differ between jurisdictions, there are a number of common indicators, including:

- (i) the relationship between the parties to the transaction, where a transaction took place directly with a related person or via a third party to a related person;
- (ii) the lack or inadequacy of the value received for the transaction;
- (iii) the financial condition of the debtor both before and after the transaction was entered into, particularly where the debtor was already insolvent or became insolvent after the transaction occurred;
- (iv) the existence of a pattern or series of transactions transferring some or substantially all the debtor's assets occurring after the onset of financial difficulties or the threat of action by creditors;
- (v) the general chronology of the events and transactions under inquiry, where for example, the transaction occurred shortly after a substantial debt was incurred;
- (vi) the transaction is concealed by the debtor, especially when it was not made in the ordinary course of business, or fictitious parties were involved; or
- (vii) the debtor absconds.

317. Some laws also specify circumstances in which there may be a presumption of intent or specify those transactions where intent or bad faith is deemed to exist, for example, in the case of transactions involving related persons occurring within a specified period of time prior to the commencement of proceedings (discussed further below). Under other laws it may be sufficient for a transaction to be avoided if the debtor could, and therefore should, have realised that the effect, if not the intent, of a transaction would have been to disadvantage creditors and that the beneficiary could and therefore should have realised that the debtor's action could produce that effect. Some laws also provide that certain transfers, such as conveyances of land, will be exempt from avoidance under this category of transactions if the transfer was bona fide for good value to a person who had no notice or was unaware of any intent to defraud the creditors.

**(b) Undervalued transactions**

*(i) Criteria*

318. A debtor who is in need of cash may sell assets quickly at a price significantly below the real value in order to achieve a quick sale, without ever having any intention to defeat or delay creditors. The result, however, may be a clear reduction of the assets available to creditors in insolvency. For this reason, many insolvency laws focus on the exchange of value in a transaction by making transactions generally avoidable where the value received by the debtor as the result of the

transaction with a third party was either nominal or non-existent, such as a gift, or much lower than the true value or market price of the asset disposed of or the obligation incurred, provided the transaction occurred within the suspect period. Other laws also require a finding that the transaction had a catastrophic effect on the debtor, such as the debtor was left with an unreasonably small amount of capital as a result of the transaction, was insolvent at the time the transaction occurred, or became insolvent as a result of the transaction. These undervalued transactions include those with both creditors and third parties.

319. An important question in respect of these types of transactions is what constitutes a sufficient “undervalue” for the purposes of avoidance and how it can be determined. In many countries, it is left to the courts to determine by reference to standards such as reasonable or market value prevailing at the time the transaction occurred on the basis of appropriate expert evidence. Where the relevant amounts in a transaction may not be certain, one approach to assist the court may be for the insolvency representative to provide the court with an estimated valuation of such amounts, which could be disputed upon the presentation of further evidence by the counterparty to the transaction. The court might also be given a power to specify a mode of determining the valuation rather than necessarily being required to determine the value itself. Given the difficulties in proving undervalue, in some jurisdictions it may be easier to avoid a transaction on the grounds of preferential effect if it was entered into at a time when the company was unable to pay its due debts. Further, some laws presume less than fair, or no, consideration to be evidence of a transaction intended to defeat, hinder or delay creditors.

(ii) *Defences*

320. Some insolvency laws provide that these types of transactions will not be avoided if certain conditions are satisfied, such as that the beneficiary acted in good faith, that the transaction was for the purpose of carrying on the debtor’s business, that there were reasonable grounds for believing that the transaction would benefit the debtor’s ordinary business and, where cessation of payments is a relevant requirement, that the debtor’s assets exceeded its liabilities at the time of the transaction (i.e. it was solvent).

(c) **Preferential transactions**

(i) *Criteria*

321. Preferential transactions may be subject to avoidance where (i) the transaction took place within the suspect period; (ii) the transaction involves a transfer to a creditor on account of a pre-existing debt; and (iii) as a result of the transaction, the creditor receives a larger percentage of its claim from the debtor’s assets than other creditors of the same rank or class (in other words, a preference). Many insolvency laws also require that the debtor was insolvent or close to insolvent when the transaction took place, and some also require that the debtor have an intention to create a preference. The rationale for including these types of transactions within the scope of avoidance provisions is that when they occur very close to the commencement of proceedings, a state of insolvency is likely to exist and they breach the key objective of equitable treatment of similarly situated creditors, by giving one member of a class more than they would otherwise legally be entitled to receive.

322. Examples of preferential transactions may include payment or set-off of debts not yet due; performance of acts which the debtor was under no obligation to perform; provision of security to secure existing unsecured debts; unusual methods of payment, other than in money, of debts that are due; payment of a debt of considerable size in comparison to the assets of the debtor; and, in some circumstances, payment of debts in response to extreme pressure from a creditor, such as litigation or attachment, where that pressure has a doubtful basis. A setoff, while not avoidable as such, may be considered prejudicial when it occurs within a short period of time before the application for commencement of the insolvency proceedings and has the effect of altering the balance of the debt between the parties in such a way as to create a preference or where it involves transfer or assignment of claims between creditors to build up setoffs. It may also be subject to avoidance where the setoff occurs in irregular circumstances such as where there is no contract between the parties to the setoff.

(ii) *Defences*

323. One defence to an allegation of a preferential transaction may be to show that although containing the elements of a preference the transaction was in fact consistent with normal commercial practice and, in particular, with the normal course of business between the parties to the transaction. For example, a payment made on receipt of goods that are regularly delivered and paid for may not be preferential even if made within proximity of the commencement of insolvency proceedings. This approach encourages suppliers of goods and services to continue to do business with a debtor which may be having financial problems, but which is still potentially viable. Other defences available under insolvency laws (depending upon applicable avoidance criteria) include that the beneficiary extended credit to the debtor after the transaction and this credit has not been paid (the defence is limited to the amount of the new credit); that the beneficiary gave new value for which it received no security; the beneficiary can show that it did not know a preference would be created; the beneficiary did not know or could not have known that the debtor was insolvent at the time of the transaction; or that the debtor's assets exceeded its liabilities at the time of the transaction.

(d) **Security interests**

324. While security interests effective and enforceable under the laws permitting the grant of a security interest to creditors should generally be regarded as valid under insolvency law, they may nevertheless be avoidable in insolvency proceedings on the same grounds that any other transaction might be challenged and avoided. The purpose of such an approach is to prevent a debtor that is not able to pay its debts from encumbering assets unless the security interest provided is in consideration of new funds being advanced. Otherwise the encumbered assets will not be available to creditors generally and will place restrictions on the debtor's use of those assets. A transaction granting a security interest might be avoided on the basis that it is a transaction intended to defeat, delay or hinder creditors, or a preferential or undervalued transaction. In many cases it will be a preferential transaction because it involves an existing creditor. For example, the grant of a security interest shortly before commencement of proceedings, although otherwise valid, may be found to have favoured unfairly a certain creditor at the expense of the rest. Where the security interest is granted to secure a prior debt or on the basis

of past consideration (permitted in some legal systems, but not in others) it may also be invalid as favouring that particular creditor unfairly. Payments received by a secured creditor might be regarded as preferential (at least in part) if a secured creditor who is undersecured is paid in full within the suspect period. Where the security interest is granted to a new creditor, the transaction may not be preferential within the meaning of that category of transaction, but may be covered by another category. There are examples of laws that include provisions dealing specifically with the avoidance of such transactions, especially in the context of security interests in favour of directors (which might also be covered by provisions on transactions with related persons) to which different criteria apply in terms of provision of value and the suspect period.

325. Avoidance provisions may also apply to a secured interest that was not perfected under the relevant secured transactions law and, under some laws, to a secured interest perfected within a short period before the commencement of proceedings, as well as to transfers to a secured creditor from the proceeds of an encumbered asset, where the transaction creating the security interest was tainted.

**(e) Transactions with related persons**

326. As noted above, one criterion relevant to avoidance of certain transactions is the relationship between the debtor and the counterparty. Where the types of transactions subject to avoidance involve related persons (sometimes referred to as connected persons or insiders), insolvency laws often provide stricter rules, particularly with regard to the length of suspect periods and treatment of any claim by the related person (see chapter V.A), as well as presumptions or shifted burdens of proof (see below) to facilitate avoidance proceedings and dispensing with requirements that the debtor was insolvent at the time of the transaction, or was rendered insolvent as a result of the transaction. A stricter regime may be justified on the basis that these parties are more likely to be favoured and tend to have the earliest knowledge of when the debtor is, in fact, in financial difficulty.

327. Related persons are generally defined by varying levels of connection to the debtor. Most jurisdictions regard those with some form of corporate or family relationship with the debtor as related persons. The legislative approach taken is generally, but not always, prescriptive. With regard to those with some form of business association with the debtor, a narrow approach would focus on the directors or management of the debtor, while a wider definition may extend not only to those who have effective control of the debtor, but may include all employees of the debtor and guarantors of the debts of any person with a business connection to the debtor. Similarly, a family relationship may be defined to include relatives by blood or marriage and even, in some laws, persons living in the same household as the debtor, as well as trustees of any trust of which the debtor or a person connected with the debtor is a beneficiary. Relatives of those who have a business association with the debtor are also commonly regarded as related persons. An important element in many jurisdictions is to include as related persons those who had a defined relationship with the debtor in the past or may have a defined relationship in the future.

328. Where the debtor is a natural person, other legislation (such as that dealing with marital property) may be relevant and may affect the operation of the insolvency law in terms of transactions that can be avoided, such as by

supplementing or limiting the avoidance provisions of the insolvency law. It is desirable that these laws are aligned and that any affect on the insolvency law is clearly stated in the insolvency law.

#### **4. Transactions exempt from avoidance actions**

329. It may be desirable for an insolvency law to include specific exemptions from the operation of avoidance powers for certain types of transactions. These might include transactions that occur in the course of implementing a reorganization plan, including those relating to post-commencement finance, payments made pursuant to a plan approved by the court under expedited reorganization proceedings or payments made pursuant to a voluntary restructuring agreement (approved between the debtor and at least a majority of unsecured creditors), where the implementation of the plan or arrangement fails and the proceedings are subsequently converted to liquidation or, in the case of the negotiated agreement, liquidation proceedings are commenced. Transactions essential to the functioning of financial markets, such as close-out netting of securities and derivative contracts (see chapter II.H) should be exempted from the operation of avoidance provisions.

#### **5. Effect of avoidance—void or voidable transactions**

330. Where a transaction falls into any of the categories of transactions subject to avoidance, insolvency laws either render it automatically void or make it voidable, depending upon the test that is adopted in respect of each category of transaction. For example, those laws which refer only to transactions occurring within a certain fixed period of time and include no subjective criteria, sometimes specify that relevant transactions will be void. However, even where that approach is adopted the insolvency representative may have to commence proceedings to recover the assets or their equivalent value from the counterparty where the counterparty fails to return the assets.

331. In those laws where the transaction is voidable, the insolvency representative will be required to decide whether the avoidance of the transaction will be beneficial to the estate, taking into account the elements of each category of avoidable transaction as well as possible delays in recovering either the assets involved or the value of the assets and the possible costs of litigation. That discretion would generally be subject to the insolvency representative's obligation to maximize the value of the estate, and it may be responsible for its failure to do so.

#### **6. Establishing the suspect period**

332. Most insolvency laws explicitly specify the duration of the suspect period with reference to the particular types of transactions to be avoided and indicate the date from which the period is calculated retroactively. For example, so many days or months before a particular event or date such as the making of the application for commencement of proceedings, the commencement of insolvency proceedings or the date decided by the court as being the date on which the debtor ceased paying its debts in the normal way ("cessation of payments"). The event or date specified by the law will depend upon other design features of the insolvency regime such as the requirements for commencement and whether there is a potential for delay between the application for and commencement of insolvency proceedings. For example, if commencement typically takes several months from the time of application and the

suspect period is a fixed period relating back from the time of commencement, then several months of that period will be used to cover the period of delay between application and commencement, limiting the potential effectiveness of the avoidance powers. However, if the application operates to automatically commence proceedings, the same delay will not occur. To address situations where there is the potential for delay between application and commencement, an insolvency law could stipulate that the suspect period apply retroactively from application and address transactions between application and commencement in other terms, such as whether they were fraudulent or whether they were in the ordinary course of business or, where an interim insolvency representative is appointed, in terms of unauthorized transactions (see chapter II.B). Where commencement occurs shortly after application, the suspect period could apply retroactively from commencement.

333. A related issue is whether suspect periods stipulated in the insolvency law can be extended by the court in appropriate situations, such as where transactions, which occurred outside the specified suspect periods in questionable circumstances, had the effect of diminishing the estate. While a discretionary approach may allow a certain degree of flexibility with respect to the transactions to be caught by the avoidance provisions, it may also lead to delay in the proceedings and does not give a predictable or transparent indication to creditors as to the transactions that are likely to be avoided. If transactions can be unwound where they took place at some unspecified time prior to the commencement of insolvency proceedings and subject to the discretion of the court, there is likely to be less safety in commercial and financial transactions. For these reasons, it is desirable that an extension of the suspect period be limited to transactions intended to defeat, hinder or delay, where issues of commercial certainty are of less concern.

334. Some insolvency laws provide one suspect period for all types of avoidable transactions, while others have different periods depending upon the type of transaction and whether the transferee was a related person. As noted above there are also examples of laws which adopt the approach of combining a short suspect period within which certain types of transactions are automatically avoided (and no defences are available) and a longer period where additional elements have to be proved. Because some transactions involve intentionally wrongful conduct, many insolvency laws do not limit the time period within which these types of transactions must have occurred in order for them to be avoided. Other insolvency laws establish a very long limit (examples range from one to ten years) where the suspect period is generally calculated from the date of commencement of proceedings.

335. Where preferential and undervalued transactions involve creditors who are not related persons, the suspect period may be relatively brief, perhaps no more than several months (examples range from three to six months). However, where related persons are involved, many countries apply stricter rules, and longer suspect periods (for example two years as opposed to three to six months where the transaction does not involve a related person are not uncommon).

## **7. Conduct of avoidance proceedings**

### **(a) Parties who may commence**

336. Avoidance of a particular transaction generally requires an application to the court to declare the transaction void, and insolvency laws adopt a variety of

approaches to the party that may commence such a proceeding. Recognising the central role played by the insolvency representative with respect to the administration of the estate, many insolvency laws provide that proceedings for the avoidance of specified transactions should be taken by the insolvency representative, although some do require the insolvency representative to gain the agreement of creditors, or a majority of creditors before any proceeding can be commenced. There are also laws that permit avoidance proceedings to be commenced by creditors (and, in some cases, the creditors committee), some of which limit the right to commence to those creditors whose debt precedes the challenged transaction in time. Some of the laws that permit creditors to commence such proceedings require the consent of the insolvency representative to be obtained. Should it be regarded as desirable to permit creditors to take such actions, requiring the insolvency representative's consent ensures the insolvency representative is informed as to what creditors propose and gives the insolvency representative the opportunity to refuse permission, thus avoiding any negative impact of such avoidance proceedings on administration of the estate.

337. Where the consent of the insolvency representative is required, but not obtained, some insolvency laws permit the creditor(s) to seek court approval for the commencement of avoidance proceedings. The insolvency representative has a right to be heard in any resulting court hearing to explain why it believes the proceedings should not go ahead. At such a hearing, the court might give leave for the avoidance proceeding to be commenced, or may decide to hear the case on its own merits. Such an approach may work to lower the likelihood of any deal-making between the various parties. Where creditor-initiated avoidance actions are available, some laws require creditors to pay the costs of any action or allow sanctions to be imposed on creditors to discourage potential creditor abuse of avoidance proceedings.

338. Where the insolvency representative has the sole power to commence avoidance proceedings and, based on the balance of the considerations discussed above, (that is for reasons other than negligence, bad faith, or omission<sup>67</sup>), decides not to commence proceedings in respect of certain transactions, insolvency laws adopt different approaches to the conduct and funding of those proceedings. The manner in which they may be funded may be of particular importance where there are insufficient assets in the insolvency estate to do so (funding is discussed further below). As to the conduct of those proceedings, some laws permit a creditor or the creditor committee to require the insolvency representative to initiate an avoidance proceeding where it appears to be beneficial to the estate to do so or also permit a creditor itself or the creditor committee to commence proceedings to avoid these transactions, where other creditors agree.

339. Where creditors are permitted to commence avoidance proceedings, either on an equal basis with the insolvency representative or because the insolvency representative decides not to commence such proceedings, insolvency laws adopt different approaches to the assets or value recovered. The most common approach is to treat the assets or value recovered by the creditor as part of the estate on the basis that the principal justification of avoidance proceedings is to return value or assets to the estate for the benefit of all creditors, not to provide a benefit to individual creditors. Other laws provide that whatever is recovered can be applied in the first

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<sup>67</sup> See chapter III.B on the rights and obligations of the insolvency representative.

instance to satisfy the claim of the creditor which takes the action; or that the priority of the claim of the creditor pursuing the action can be modified.

**(b) Funding of avoidance proceedings**

340. The most crucial restriction in a number of countries on the efficacy of avoidance provisions has been the unavailability of funds with which to challenge potentially avoidable transactions. Different approaches to the question of funding have been adopted. Some countries make public funds available to the insolvency representative to commence avoidance proceedings, while other countries require those proceedings to be funded from the insolvency estate. This latter approach may be appropriate where sufficient funds exist but in some circumstances would prevent the recovery of assets that have been removed from the estate with the specific intention of leaving the estate with few assets from which to fund their recovery through an avoidance proceeding. Some insolvency laws allow the insolvency representative to assign the ability to commence proceedings for value to a third party or to approach a lender to advance funds with which to commence the avoidance proceeding. There are clearly significant differences between countries in the availability of public resources to fund avoidance proceedings that may justify use of some of these alternative mechanisms. Where there is no ability to fund avoidance proceedings from the insolvency estate, these alternative approaches may offer, in appropriate situations, an effective means of restoring value to the estate, avoiding abuse, investigating unfair conduct and furthering good governance.

**(c) Time limits for commencement**

341. Some insolvency laws establish specific time periods within which avoidance proceedings should be commenced, while others are silent on this issue. Those laws that do specify time periods provide, for example, that the proceeding should be commenced within a specified period after the date of commencement of proceedings (such as three or twelve months) or no later than a specified time period (for example, six months) after the insolvency representative is able to discover, assess and pursue claims. If an insolvency law is to establish specific time periods, rather than relying on those applicable under general law, an approach that combines different periods, such as a fixed time period after commencement and a fixed time period after the discovery of the transaction by the insolvency representative, would be desirable. Such an approach provides flexibility sufficient to address those transactions that are concealed from the insolvency representative and discovered only after the expiration of the specified time period.

**(d) Satisfying the criteria for avoidance**

342. Insolvency laws adopt different approaches to establishing the elements that have to be proved in order to avoid a particular transaction. The approach adopted will depend upon how the balance is struck between undoing transactions that are unfair or financially harmful to insolvency estate on the one hand and protecting commercial transactions that are not regarded as wrong or harmful outside the insolvency context.

343. In some laws, the onus is on the debtor to prove that the transaction did not fall into any category of avoidable transactions. Other insolvency laws provide that the insolvency representative or other person permitted to challenge the transaction,



such as a creditor, is required to prove that the transactions satisfies the requirements for avoidance. Where these elements include intent, it will often be very difficult to prove and the party with the burden of proof will most often lose. To overcome this difficulty, some laws allow the burden of proof to be shifted to the counterparty where, for example, it is difficult for the insolvency representative to establish that the debtor's actual intent was to defraud creditors except through external indications, objective manifestations, or other circumstantial evidence of such intent, although as a practical matter the debtor's inability to satisfactorily explain the commercial purpose of a particular transaction which extracted value from the estate may point to the requisite intent.

344. Another approach is to provide that the requisite intent or bad faith is deemed or presumed to exist where certain types of transactions are undertaken within the suspect period and the counterparty to the transaction will have the burden of proving otherwise. These types of transactions may include, for example, transactions with related persons, payment of non-matured debts, and payment of gratuitous or onerous transactions. A further approach is to provide that where a certain type of transaction occurred within the suspect period and had a certain effect, such as conferring a preference, a rebuttable presumption as to intention to prefer will arise. Unless the creditor can rebut the presumption, the transaction is avoided and the insolvency representative can recover the assets involved in the transaction or obtain judgement for the value of the asset involved.

345. Where the counterparty's knowledge of the debtor's insolvency is a required element of avoidance, some insolvency laws provide a presumption that the counterparty knew of the poor financial condition of the debtor if the transaction entered into with that person had certain characteristics, such as for repayment of a non-mature debt or repayment in an unusual manner, or where the transaction occurred within a short period before an application for commencement or before commencement.

346. Whichever approach an insolvency law adopts to satisfying the avoidance criteria, it is highly desirable that the law state precisely which parts of the criteria have to be proved by which party, so that it is clear what is required of the insolvency representative in seeking to avoid a particular transaction and what is required of the counterparty seeking to defend a transaction from avoidance.

## **8. Liability of counterparties to avoided transactions**

347. Where a transaction is avoided, there is a question of the effect of avoidance on the counterparty. In most insolvency laws the result of avoidance of a transaction is generally that the transaction will be reversed and the counterparty required to return the assets obtained or make a cash payment for the value of the transaction to the insolvency estate. Some insolvency laws provide that the insolvency representative can be awarded judgement for the value of the property involved. Some insolvency laws also stipulate that the counterparty who has returned assets or value to the estate may make a claim as an unsecured creditor in the insolvency to the extent of the assets returned in the case of a preference and to the extent of the consideration paid in an undervalued transaction. Where the counterparty fails to disgorge assets or return value to the insolvency estate, most of remedies available are under non-insolvency law, but some insolvency laws provide that in addition to avoidance of the transaction, a claim by the counterparty (for amounts owed in

addition to those involved in the voidable transaction) cannot be admitted in the insolvency.

## 9. Conversion of reorganization to liquidation

348. Where reorganization proceedings are converted to liquidation proceedings, some consideration may need to be given to the effect of that conversion on the exercise of avoidance powers in respect of payments made in the course of the reorganization proceedings and the timing of the suspect period.

## Recommendations

### Purpose of legislative provisions

The purpose of avoidance provisions is to:

- (a) reconstitute the integrity of the estate and ensure the equitable treatment of creditors;
- (b) provide certainty for third parties by establishing clear rules for the circumstances in which transactions occurring prior to the commencement of insolvency proceedings involving the debtor or the debtor's property may be considered injurious and therefore subject to avoidance;
- (c) enable the commencement of proceedings to avoid those transactions;
- (d) facilitate the recovery of money or assets from persons involved in transactions that have been avoided.

### Contents of legislative provisions

#### *Avoidable transactions*

(73) The law should include provisions which apply retroactively and are designed to overturn transactions,<sup>68</sup> involving assets of the debtor or the estate and which have the effect of either reducing the value of the estate or upsetting the principle of equitable treatment of creditors. The law should specify the following types of transactions as avoidable:

- (a) transactions intended to defeat, delay or hinder the ability of creditors to collect claims where the purpose of the transaction was to put assets beyond the reach of a creditor or potential creditor or to otherwise prejudice the interests of that creditor and where the counterparty knew or should have known of the debtor's intent;
- (b) transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was made in exchange for a nominal or less than equivalent value or for inadequate value which occurred at a time when the debtor was insolvent or as a result of which the debtor became insolvent (undervalued transactions); and

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<sup>68</sup> The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security, a guarantee, a loan or a release [or an action to make the security interests effective against third parties] and may include a composite series of transactions.

(c) transactions involving creditors where a creditor obtained, or received the benefit of, more than its pro rata share of the debtor's assets which occurred at a time when the debtor was insolvent (preferential transactions).

*Security interests*

(74) The law should specify that:

(a) where a security interest is effective and enforceable under other law, that effectiveness and enforceability will be recognized in insolvency proceedings;

(b) notwithstanding that a security interest is effective and enforceable under other law, it may be subject to the avoidance provisions of the law on the same grounds as other transactions.

*Establishing the suspect period*

(75) The law should specify that the transactions described in recommendation (73)(a)-(c) may be avoided if they occurred within a specified period (the suspect period) calculated retroactively from a specified date, being either the application for or commencement of the insolvency proceedings. The law may specify different suspect periods for different types of transactions.

*Related person transactions*

(76) In relation to avoidable transactions involving related persons, the law may:

(a) specify that the suspect period for those transactions is longer than for transactions with unrelated persons;

(b) establish [evidentiary][rebuttable] presumptions to facilitate avoidance proceedings; and

(c) permit shifts in the burden of proof to facilitate avoidance proceedings.

(77) The law should specify the categories of persons with sufficient connection to the debtor to be treated as related persons.<sup>69</sup>

*Transactions exempt from avoidance actions*

(78) The law should specify the transactions that are exempt from avoidance, including financial contracts.

*Conduct of avoidance proceedings*

(79) The law should specify that:

(a) the insolvency representative has the principal responsibility to commence avoidance proceedings;<sup>70</sup>

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<sup>69</sup> "Related person" is defined in the Glossary.

<sup>70</sup> Issues relevant to avoidance may also arise in proceedings commenced by a person other than the insolvency representative, where the insolvency representative raises avoidance by way of defence against enforcement.

(b) any creditor may commence avoidance proceedings with the agreement of the insolvency representative; or

(c) where the insolvency representative does not agree, the creditor may seek leave of the court.

*- Funding of avoidance proceedings*

(80) The law may provide alternative approaches to address the funding of avoidance proceedings where the insolvency representative elects not to pursue the avoidance of particular transactions on the basis, for example, of an assessment that the transactions are not likely to be avoided or that pursuing those transactions will impose excessive costs<sup>71</sup> upon the insolvency estate.

*- Time limits for commencement of avoidance proceedings*

(81) The law or applicable procedural law should specify the time period within which an avoidance proceeding may be commenced. That time period should begin to run on the commencement of insolvency proceedings. [In respect of transactions referred to in recommendation (73)(a) which have been concealed and which the insolvency representative could not be expected to discover, the law may provide that the time period commences at the time of discovery.]

*Elements of avoidance and defences*

(82) The law should specify the elements to be proved in order to avoid a particular transaction, the party responsible for proving those elements and specific defences to avoidance. Those defences may include that the transaction was entered into in the ordinary course of business prior to commencement of insolvency proceedings, or that the transaction was entered into in the course of reorganization proceedings which were subsequently converted to liquidation proceedings.

*Liability of counterparties to avoided transactions*

(83) The law should specify that a counterparty to a transaction that has been avoided must return to the estate the assets obtained or, if the court so orders, make a cash payment to the estate for the value of the transaction. [The court should determine whether the counterparty to an avoided transaction would have an ordinary unsecured claim.]

(84) The law may specify that where the counterparty does not comply with the court order avoiding the transaction, in addition to avoidance and any other remedy, a claim by the counterparty may be disallowed.

## **G. Rights of set-off**

349. The enforcement under insolvency law of rights of set-off of mutual obligations arising out of pre-commencement transactions or activities of the debtor

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<sup>71</sup> This refers to an appraisal of the costs and benefits of an avoidance action and an implicit rule that if the costs of proceedings would exceed the benefits to be recovered for the estate, those proceedings should not go ahead.

is important not only to commercial predictability and the availability of credit, but also because it avoids the strategic misuse of insolvency proceedings. For these reasons, it is highly desirable that an insolvency law affords protection to such set-off rights.

350. In the majority of jurisdictions, set-off rights are not affected by the stay in insolvency and may be exercised after the commencement of insolvency proceedings, irrespective of whether the mutual obligations arose under a single contract or multiple contracts and irrespective of whether the mutual obligations matured before or after commencement of insolvency proceedings. In some jurisdictions a distinction is made; post-commencement set-off of obligations maturing prior to the commencement of insolvency proceedings is permitted, but post-commencement set-off of obligations maturing after the commencement of insolvency proceedings is limited or disallowed.

351. An alternative approach preserves set-off rights regardless of whether the mutual obligations matured prior to or after the commencement of insolvency proceedings, but applies the stay to the exercise of those rights in the same manner as the stay applies to the exercise of rights of secured creditors. In systems adopting this alternative approach, the creditor is treated as secured to the extent of its own valid but unexercised set-off rights and these rights are protected in a manner similar to the protections afforded to security interests.<sup>72</sup>

352. Insolvency laws almost universally include provisions that permit the insolvency representative to seek to avoid the effects of certain pre-commencement actions by creditors designed to enhance set-off rights (such as purchasing claims at a discount with the intention of building up set-off rights). The nature and scope of these provisions varies.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on set-off is to:

- (a) Provide certainty with respect to the effect of the commencement of insolvency proceedings upon the exercise of set-off rights;
- (b) Specify the types of obligations that may be set-off after commencement of insolvency proceedings;
- (c) Specify the effect of other provisions of the law (e.g. avoidance provisions and the stay) on the exercise of rights of set-off.

### **Contents of legislative provisions**

(85) The law should protect a general right of set-off existing under general law that arose prior to the commencement of insolvency proceedings, subject to the application of avoidance provisions.

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<sup>72</sup> See chapter II.B.8.

## H. Financial contracts and netting

353. Financial contracts have become an important component of international capital markets. Among other things, they enhance the availability of credit and are an important means of hedging against exchange rate, interest rate and other market fluctuations. Because of the way these transactions are structured and documented, it is imperative that there be certainty as to what happens when one of the parties to such contracts fails to perform—including for reasons of insolvency.

354. Financial contracts include, among other things, securities contracts, commodities contracts, forward contracts, options, swaps, securities repurchase agreements, master netting agreements and other similar contracts. Debtors often enter into multiple financial contracts with a given counterparty in a single course of dealing, and the availability of credit is enhanced if rights under these contracts are fully enforceable in accordance with their terms, thereby permitting counterparties to extend credit based on their *net exposure* from time to time after taking into account the value of all “open” contracts.

355. Upon commencement of insolvency proceedings, counterparties seek to “close-out” open positions and “net” all obligations arising under financial contracts with the debtor. “Close-out netting” embraces two steps: first, termination of all open contracts as a result of the commencement of insolvency proceedings (close-out); second, the set-off of all obligations arising out of the closed out transactions on an aggregate basis (netting).

356. Permitting “close-out netting” after the commencement of insolvency proceedings is an important factor in mitigating systemic risks that could threaten the stability of financial markets. The value of or exposure under a financial contract may vary significantly from day to day (and sometimes from hour to hour) depending on conditions in the financial markets. Accordingly, the value of these contracts can be highly volatile. Counterparties typically mitigate or hedge the risks associated with these contracts by entering into one or more “matching” or “hedge” contracts with third parties, the value of which fluctuates inversely with the value of the debtor’s contract.<sup>73</sup>

357. Whether or not the debtor performs its contract with the counterparty, the counterparty must perform the hedge contract it enters into with third parties. If the debtor becomes insolvent and cannot perform its contract with the counterparty, the counterparty becomes exposed to market volatility because the counterparty’s hedge positions are no longer “covered” by its contract with the debtor. Under such circumstances, the counterparty typically seeks to “cover” the hedge contracts by entering into one or more new contracts so as to limit its exposure to future market fluctuations. The counterparty cannot, however, cover in this manner until it determines with certainty that it will not be required to perform its contract with the debtor. The counterparty relies on the ability to “close-out” the debtor’s contract, which permits it to “cover” promptly after the commencement of insolvency proceedings.

358. Without the ability to close-out, net and set-off obligations in respect of defaulted contracts promptly after commencement as described above, a debtor’s

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<sup>73</sup> The reference to a “contract” in this section includes the possibility of one or more contracts.

failure to perform its contract (or its decision to perform profitable contracts and not perform unprofitable ones) could lead the counterparty to be unable to perform its related financial contracts with other market participants. The insolvency of a significant market participant could result in a series of defaults in back-to-back transactions, potentially causing financial distress to other market participants and, in the worst case, resulting in the financial collapse of other counterparties, including regulated financial institutions. This domino effect is often referred to as “systemic risk”, and is cited as a significant policy reason for permitting participants to close-out, net and set-off obligations in a way that normally would not be permitted by insolvency law.

359. Systemic risk can also arise from concerns over the finality of payments and settlements of financial contracts that take place in central payment and settlement systems. These systems employ either bilateral or multilateral netting arrangements. The netting of financial contracts through these systems and the finality of clearing and settlement through these systems should be recognized and protected upon the insolvency of one of the participants in the system in order to prevent systemic risk.

360. In many countries, the application of general insolvency rules will allow the financial contracts to be performed in accordance with their terms following commencement of insolvency proceedings by giving effect to contract termination clauses triggered by insolvency (see chapter II.E.2 and recommendations (56)-(57)) and by allowing for the set-off of obligations, whether a claim for breach is based on an automatic termination clause or arises pre-commencement. Other jurisdictions, with insolvency provisions that limit the effect of automatic termination clauses or that stay or limit the exercise of set-off rights and other creditor remedies, require specific exceptions in their insolvency laws to permit full enforcement of remedies in respect of financial contracts. It is also desirable that the exceptions also extend to avoidance provisions that might apply to financial contracts and any restrictions that would limit the extent to which security can be applied to unsatisfied financial contract obligations remaining after offsets are completed.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provision on netting and set-off in the context of financial transactions is to reduce the potential for systemic risk that could threaten the stability of financial markets by providing certainty with respect to the rights of parties to a financial contract when one of those parties fails to perform for reasons of insolvency.

### **Contents of legislative provisions**

(86) The law should recognize contractual termination rights associated with financial contracts that permit the termination of those contracts and the set-off and netting of outstanding obligations under those contracts promptly after the commencement of insolvency proceedings. Where the law stays the termination of contracts or limits the enforceability of automatic termination clauses on

commencement of insolvency proceedings, financial contracts should be exempt from such limitations.<sup>74</sup>

(87) Once the financial contracts of the debtor have been terminated by a counterparty, the law should permit the counterparty to net or set-off obligations under those terminated financial contracts to establish a net exposure position relative to the debtor. This termination and set-off to establish a net exposure should be permitted regardless of whether the termination of the contracts occurs prior to or after the commencement of insolvency proceedings. Where the law limits or stays the exercise of set-off rights upon commencement of insolvency proceedings, set-off and netting of financial contracts should be exempt from such limitations.

(88) Once the financial contracts of the debtor have been terminated, the law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest.

(89) The law should specify that routine pre-bankruptcy transfers consistent with market practice, such as the putting up of margin for financial contracts<sup>75</sup> and transfers to settle financial contract obligations<sup>76</sup> should be exempt from avoidance.

(90) The insolvency law should recognize and protect the finality of the netting, clearing and settlement of financial contracts through payment and settlement systems upon the insolvency of a participant in the system.

(91) Recommendations (86) to (90) should apply to all transactions that are considered to be “financial contracts,” whether or not one of the counterparties is a financial institution.<sup>77</sup>

(92) Financial contracts should be defined broadly enough to encompass existing varieties of financial contracts and to accommodate new types of financial contracts as they appear. [These recommendations are not intended to apply to transactions that are not financial contracts and they would remain subject to the general law applying to set-off and netting.]

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<sup>74</sup> This will allow market participants to extend credit based on “net” positions and make it impossible for the debtor to “cherry pick” contracts by performing some and breaching others, which is especially important with regard to financial contracts because of systemic risk.

<sup>75</sup> Margin is the process of posting additional cash or securities as a security for the transactions in accordance with a contractual formula that accounts for fluctuations in the market value of the contract and the existing security. For example, on a swap, a margin of 105 per cent might be required to maintain the termination value of the contract. If the security position falls to 100 per cent, an additional margin might be required to be posted.

<sup>76</sup> In some circumstances, a settlement payment might be viewed as a preference. In the example of a swap, settlement payments are to be made monthly or upon termination of the contract based on the market value of the contract. These payments are not value for value transfers, but rather payment of an accrued debt obligation that has matured. In countries that have a fixed suspect period for all transactions occurring before commencement, such a payment might also be subject to avoidance.

<sup>77</sup> Even if a given financial contract does not involve a financial institution, the impact of the insolvency of a counterparty could entail systemic risk.



### III. Participants

#### A. The debtor<sup>78</sup>

##### 1. Introduction

361. Insolvency laws adopt different approaches to the role the debtor plays in the insolvency proceedings once they have commenced, with a distinction generally being drawn between liquidation and reorganization. Where the business is to be continued (either for sale as a going concern in liquidation or in reorganization) a greater need arises for some form of involvement of the debtor in management. The debtor will also have a role to play in assisting the insolvency representative to perform its own functions and in providing information on the business to the court or the insolvency representative. In addition to its obligations, the debtor will have certain rights with regard to those proceedings, such as to be heard in proceedings, to access information and to retain personal property. To ensure the efficient and effective conduct of the proceedings, and provide certainty for all parties involved it is desirable that an insolvency law clearly establishes the extent of the debtor's rights and obligations.

##### 2. Continued operation of the debtor's business and the role of the debtor

###### (a) Liquidation

362. Once liquidation proceedings have commenced, the conservation of the estate requires comprehensive measures to protect the estate not only from the actions of creditors (see chapter II.B) but also from the debtor. For this reason, many insolvency laws divest the debtor of all rights to control assets and manage and operate the business in liquidation, and appoint an insolvency representative to assume all responsibilities divested. In addition to the powers relating to use and disposal of assets, these responsibilities may include the right to initiate and defend legal actions on behalf of the estate and the right to receive all payments directed to the debtor. After commencement of the liquidation proceedings, any transaction involving assets of the estate, including transfer of those assets, which is not authorized by the insolvency representative, the court or creditors (depending on the requirements of the insolvency law) generally will be void (or under some laws subject to avoidance), and the assets transferred (or their value) subject to recovery for the benefit of the insolvency estate (see chapter II.E.7, II.F.8).

363. Where it is determined that the most effective means of liquidating the estate is to sell the business as a going concern, some laws provide that the insolvency representative should supervise and have overall control of the business while permitting the debtor to enhance the value of the estate and facilitate the sale of the assets by continuing to serve and advise the insolvency representative. This approach may be supported by the debtor's detailed knowledge of its business and

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<sup>78</sup> Because the insolvency law will cover different types of businesses, whether individuals, partnerships or some form of company, the question of the continuing role of the debtor properly raises questions of the role of the debtor's management or owners, depending upon the circumstances. For ease of reference, the Guide refers only to "the debtor", but it is intended that management and owners should be covered by the use of that term where appropriate.

the relevant market or industry, as well as its ongoing relationship with creditors, suppliers and customers.

**(b) Reorganization**

364. In reorganization proceedings, there is no agreed approach on the extent to which displacement of the debtor is the most appropriate course of action and, where some level of displacement does occur, on the ongoing role that the debtor may perform and the manner in which that role is balanced with the roles of other participants. That ongoing role may depend in large part upon the debtor acting in good faith during the reorganization process; where it does not, its continuing role may be of questionable value. It may also depend upon the existence of a strong, independent governance regime that can address incompetent or self-serving behaviour. Sometimes the advantages of a continuing role may also depend upon whether the debtor commenced the proceedings or whether they were commenced on the application of creditors. In the latter case the debtor may be uncooperative or even hostile to an extent that makes its continued participation pointless. The decision on which approach to take may depend upon a number of factors including local corporate culture; the role of banks; the existence and effectiveness of corporate governance regimes; the effectiveness of insolvency institutions; the level of supervision provided by, or required of, the courts; the effectiveness and accessibility of the courts; and the extent to which incentives to commence insolvency proceedings are determined to be of importance to the design of the insolvency regime.

*(i) Advantages and disadvantages of the debtor's continuing involvement*

365. There are a number of potential advantages in providing for the debtor to have an ongoing role. In many circumstances, the debtor will have immediate and intimate knowledge of its business and the industry within which it operates. This knowledge is particularly important in the case of individual businesses and small partnerships and may, in the interests of business continuity, provide a basis for the debtor to have a role in making short term and day-to-day management decisions. It may also assist the insolvency representative to perform its functions with a more immediate and complete understanding of the operation of the debtor's business. For similar reasons, the debtor is often well positioned to propose a reorganization plan. In such circumstances, total displacement of the debtor, notwithstanding its role in the financial difficulties of the business, may not only eliminate an incentive for entrepreneurial activity, risk-taking in general and for debtors to commence reorganization procedures at an early stage, but also may undermine the chances of success of the reorganization.

366. The desirability of the debtor having an ongoing role may need to be balanced against a number of possible disadvantages. Creditors may have a lack of confidence in the debtor on account of the financial difficulties of the business (and the role that the debtor may have played in these difficulties) and confidence will need to be rebuilt if the reorganization is to be successful. Permitting the debtor to continue to operate the business with insufficient control over its powers may not only exacerbate the breakdown of confidence but may antagonize creditors further. One factor that may affect creditors' views of this option is the effectiveness of corporate governance regimes and the responsiveness of the debtor to that regime.

Where there are no effective governance regimes, creditors may prefer an appointed insolvency representative to displace the debtor or to have significant supervisory powers over the debtor.

367. A system which is perceived to be excessively pro-debtor may result in creditors being apathetic about the process and unwilling to participate, which in turn may lead to problems of monitoring the conduct of the debtor where the insolvency law requires that role to be played by creditors. It may also encourage an adversarial approach to the insolvency process, adding to costs and delay. A debtor may have its own agenda that clashes with the objectives of the insolvency regime and in particular with the maximization of returns for creditors. Its overriding goal, for example, may be to ensure that it does not lose control of the business rather than to maximize value for the benefit of creditors. Furthermore, the success of reorganization may depend not only upon instituting change that the debtor may not be willing to accept, but also upon the debtor possessing the knowledge and experience to utilise the insolvency law to work through its financial difficulties. A related factor to be considered is whether the insolvency proceedings were commenced on application of the debtor or of creditors (in which case the debtor may be hostile to creditors).

368. A number of insolvency laws draw a distinction, in terms of the debtor's role, between the period from commencement of proceedings to approval of the reorganization plan, on the one hand, and the period following approval of the plan, on the other hand. In the first period these laws set out specific rules concerning the debtor's ability to manage and control the day-to-day running of the business and the appointment of an independent insolvency representative. Once the plan has been approved, the limits applicable to the debtor's control and management of the business may cease to apply and the debtor will be responsible for implementation of the approved plan.

369. Insolvency laws adopt different approaches to balancing these competing considerations in reorganization. These vary between displacing the debtor and appointing an insolvency representative, at one end of the scale, and allowing the debtor to remain in control of the business with minimum supervision at the other. Intermediate approaches provide for an insolvency representative to be appointed to exercise some level of supervisory function, as well as for retention of existing management. The choice between these various approaches has implications for the structure of the insolvency regime and in particular for the balance to be achieved between the various participants and the extent to which checks and balances, whether provided by the court or creditors, will apply.

(ii) *Approaches to a continuing role for the debtor*

- *Total displacement of the debtor*

370. This approach follows the same procedure as in liquidation, removing all control of the business from the debtor and appointing an insolvency representative to undertake the debtor's functions with respect to management of the business. As noted above, however, total displacement of the debtor may cause disruption to the business and repercussions detrimental to its continuing operation at a critical point in its survival.

- *Supervision of the debtor by the insolvency representative*

371. Intermediate approaches establish different levels of control between the debtor and the insolvency representative. These generally involve some level of supervision of the debtor by the insolvency representative, such as where the latter broadly supervises the activities of the debtor and approves significant transactions, while the debtor continues to operate the business and take decisions on a day-to-day basis. This approach may need to be supported by relatively precise rules to ensure that the division of responsibility between the insolvency representative and the debtor is clear, and there is certainty as to how the reorganization will proceed. Some insolvency laws, for example, specify that certain transactions, such as entering into new debt, transferring or pledging assets and granting rights to the use of property of the insolvency estate, can be undertaken without the consent of the insolvency representative or the court provided they are undertaken in the ordinary course of business. If they are not in the ordinary course of business, consent is required. Monitoring the cash flow of the debtor's business may be an additional tool for policing the debtor and its transactions.

372. Where the debtor fails to observe the restrictions and enters into contracts requiring consent without first obtaining that consent, the insolvency law may need to address the validity of these transactions and provide appropriate sanctions for the debtor's behaviour. While one insolvency law provides, for example, that in these circumstances the court can discontinue the insolvency proceedings altogether, the appropriateness of this remedy depends not only upon whether the proceedings were commenced on the application of the debtor or creditors (the debtor should not be able to frustrate proceedings commenced on an application by creditors by failing to observe the insolvency law or orders of the court), but also upon what is in the best interests of all parties involved in the proceedings and the availability of other mechanisms in the insolvency law for addressing that type of behaviour by the debtor (including the possibility of converting reorganization proceedings to liquidation).

373. Insolvency laws that enumerate the transactions requiring consent establish a relatively clear line of responsibility between the debtor and the insolvency representative or the court. A number of these laws also provide that the insolvency representative can take greater control of the insolvency estate and day-to-day management of the business if required to protect the insolvency estate in a particular case. Appropriate circumstances may include where there is evidence of a lack of accountability on the part of the debtor, or where there is mismanagement or misappropriation of assets by the debtor. Where these circumstances arise, it may be desirable to permit the debtor to be displaced by the court, on its own motion or on that of the insolvency representative or perhaps on that of the creditors or creditor committee.

374. Creditors may have a role to play in monitoring the management activities of the debtor and ensuring that it carries them out effectively. Where creditors have such a role there may be a need for measures that would prevent possible abuse by creditors seeking to frustrate the reorganization proceedings or to gain improper leverage. The required degree of protection could be achieved by requiring, for example, the vote of an appropriate majority of creditors before allowing creditors to take action to displace the debtor or increase the supervisory role of the insolvency representative.

375. A different approach to the delineation of powers between the debtor and the insolvency representative is one where the insolvency law does not specify the transactions that the debtor may undertake, but allows the court or the insolvency representative to determine which legal acts management can perform with approval and which it cannot. While allowing some degree of flexibility, this approach may deter debtors from commencing insolvency proceedings as the effect of commencement on their management and control of the business will be unclear.

*- Full control by the debtor*

376. A further approach to the issue of the debtor's ongoing role is one that enables the debtor to retain full control over the operation of the business, with the consequence that the court does not appoint an independent representative once the proceedings commence (often known as "debtor in possession"). That approach may have the advantage of enhancing the chances of a successful reorganization if the debtor can be relied upon to carry on the business in an honest manner and obtain the trust, confidence and cooperation of creditors.

377. There may be, however, disadvantages to this approach which include it being used in situations where the outcome is clearly not likely to be successful; to delay the inevitable with the result that assets continue to be dissipated; the possibility that the debtor may act irresponsibly and even fraudulently during the period of control, undermining the reorganization as well as the confidence of creditors; and the potential for the process to offer a competitive advantage to struggling businesses if they are able to obtain cheap finance, reduced interest payments and other benefits that have the effect of lowering their costs relative to their market rivals. Some of these difficulties may be mitigated by adopting certain protections such as a requirement that the debtor report regularly on the conduct of the proceedings to the court; permitting the court, in certain circumstances, to appoint an insolvency representative to supervise the debtor; giving the creditors a significant role in supervising or overseeing the debtor; or providing for conversion of the proceedings to liquidation. It should be noted that where this approach is adopted, the management of the debtor at the commencement of the proceedings is often not the same management that is charged with implementation of an approved plan, and some of the factors noted above will not be as compelling as they may be where the debtor's management remains in place throughout the proceedings. Nevertheless, the debtor-in-possession approach is a complex one that requires detailed consideration not only because it depends upon strong corporate governance rules and institutional capacity, but also because it affects the design of a number of other provisions of an insolvency regime (e.g. preparation of the reorganization plan, exercise of avoidance powers, treatment of contracts, obtaining post-commencement finance) that are not addressed in detail in this Guide.

### **3. Rights of the debtor**

378. To preserve what are regarded in some countries as fundamental rights of the debtor and to ensure its fair and impartial treatment, and perhaps more importantly to encourage debtor confidence in the insolvency process, it is desirable that the role of the debtor in the insolvency proceedings and the rights it will have with respect to the conduct of the proceedings are clearly enumerated in the insolvency law. In many countries, the rights of a natural person debtor in insolvency proceedings may

be affected by obligations under international and regional treaties such as the International Covenant on Civil and Political Rights (1976) and the European Convention on Human Rights (1950).

*- Right to be heard, to access information and to retain personal property*

379. It is desirable, for the reasons indicated above, that the debtor has the right to be heard in the insolvency proceedings and to participate generally in the decision making that is a necessary part of the proceedings, particularly reorganization proceedings. In particular, the debtor should be able to access information relating to the progress of the proceedings in all cases, but especially where the insolvency law provides for some level of displacement of the debtor (whether in liquidation or reorganization) from management and control of the business. This access to information may be particularly important in reorganization where the insolvency law provides for some level of displacement before approval of the plan, but requires the debtor to take responsibility for the plan's implementation. It may also be appropriate, in circumstances where the debtor does not play a role in formulation of the plan, for it to be given an opportunity to express an opinion on the plan before it is submitted for approval. As noted above in chapter II.A.3, where the debtor is a natural person, certain assets are generally excluded from the insolvency estate to enable the debtor to preserve its personal rights and those of its family and it is desirable that the right to retain those excluded assets be made clear in the insolvency law.

380. There may be situations, however, where the exercise or observance of these rights leads to formalities and costs that impede the course of the proceedings without being of any direct benefit to the debtor. It may be the case, for example, that where the debtor is no longer available in the jurisdiction in which the proceedings are being conducted and refuses or fails to respond to all reasonable attempts by the insolvency representative or the court to establish contact, an absolute requirement to be heard could seriously impede progress of the proceedings, if not make them impossible to undertake. Similarly in cases where the debtor is no longer operational and cannot be heard as such, or where the shareholders and owners of the business will not participate in any distribution in the proceedings, an absolute requirement to be heard may not serve any useful purpose. For these reasons, while it is desirable to provide that all reasonable efforts to allow the debtor to be heard should be made, an insolvency law may need to provide some flexibility in exceptional cases to avoid the requirement to observe the right adversely affecting the conduct of the proceedings.

#### **4. Obligations of the debtor**

381. As noted with respect to the rights of the debtor, it is desirable that the insolvency law clearly identify the obligations of the debtor with respect to the insolvency proceedings, including, as far as possible, the content and terms of the obligations and to whom each obligation is owed. The obligations should arise on the commencement of the proceedings and continue to apply throughout the proceedings. These obligations will need to be adjusted to the role to be played by the debtor in respect of both liquidation and reorganization proceedings, especially with regard to management and control of the business in reorganization. For example, where the debtor remains in control of the business in reorganization, an

obligation to surrender control of the assets of the insolvency estate will not be applicable.

**(a) Cooperation and assistance**

382. To ensure that insolvency proceedings can be conducted effectively and efficiently, some insolvency laws that provide for some level of displacement or supervision of the debtor impose on the debtor a general obligation to cooperate with and assist the insolvency representative in performing its duties, and in some laws to refrain from conduct that might be injurious to the conduct of the proceedings. An essential part of the obligation to cooperate will be to enable the insolvency representative to take effective control of the insolvency estate by surrendering control of assets, business records and books. Where the assets of the debtor are located in a foreign jurisdiction, it may not be possible for the debtor to surrender control of those assets, but the obligation should refer to facilitating or cooperating with the insolvency representative in the recovery of those assets located abroad (see chapter VII on Model Law on Cross-Border Insolvency). The obligation to cooperate may also require the debtor to assist the insolvency representative to prepare a list of creditors and their claims, as well as a list of the debtor's debtors (see chapter III.B.4).

**(b) Provision of information**

383. To facilitate a thorough, independent assessment of the business activities of the debtor, including its immediate liquidity needs and the advisability of post-commencement financing, the prospects for the long term survival of the business, and whether management is qualified to continue to lead the business, information concerning the debtor, its assets and liabilities, financial position and affairs generally will be required. To enable that assessment to be undertaken, it is desirable that in both liquidation and reorganization, but particularly in reorganization and where the business is to be sold as a going concern in liquidation, the debtor has a continuing obligation to disclose detailed information regarding its business and financial affairs over a substantial period, not simply the period in proximity to commencement of proceedings. That detailed information may include information concerning assets and liabilities; income and disbursements; customer lists; projections of profit and loss; details of cash flow; marketing information; industry trends; information thought to concern the causes or reasons for the financial situation of the debtor; disclosure of past transactions that involved the debtor or assets of the debtor, including those that may be capable of avoidance under the avoidance provisions of the insolvency law; and information concerning outstanding contracts, transactions involving related persons and ongoing court, arbitration or administrative proceedings against the debtor or in which the debtor is involved. A number of insolvency laws also require the debtor to provide information concerning its creditors and, as noted above, to prepare, often in cooperation with the insolvency representative, a list of creditors against which claims can be verified, as well as a list of its debtors. The debtor may also be required to update the list from time to time as claims are verified and a decision as to admission is made.

384. Although it may not be necessary for an insolvency law to exhaustively detail the information that is to be provided by the debtor, such an approach may be useful

to provide guidance on the type of information that is expected to be provided. In that regard, some laws have developed standardized information forms that set out the specific information required. These are to be completed by the debtor (with appropriate sanctions for false or misleading information) or by an independent person or administrator.

385. To ensure that the information provided can be used for the purposes noted above, it needs to be up to date, complete, accurate and reliable and be provided as soon as possible after the commencement of the proceedings, subject to allowing the debtor the time necessary to collect the relevant information. Where the debtor can meet this obligation it may serve to enhance the confidence of creditors in the ability of the debtor to continue managing the business.

386. The process for eliciting the information outlined above may be central to its ultimate usefulness. If, for example, members of the management of the debtor are responsible for the debtor's current financial situation, they may be unwilling to give full and frank disclosure or to disclose information that may be self-incriminating (although many criminal laws provide that self-incriminating evidence may not be used in subsequent criminal proceedings in order to encourage frank disclosure). Accordingly, in addition to the debtor's obligation to provide information, it may be desirable for an insolvency law to give the insolvency representative and the creditors or the creditor committee the corresponding right to demand and receive information from the debtor, with appropriate sanctions where the requested information is not forthcoming. The debtor's obligation may be supplemented by additional measures, that may include appointing an independent examiner or requiring the debtor itself (where it is a natural person) or one or more of the directors of the debtor to be represented at or required to attend a main meeting of creditors to answer questions (except where this is not physically possible for geographical reasons).

**(c) Confidentiality**

387. Often the information to be provided by the debtor will be of a commercially sensitive nature, confidential or subject to obligations owed to other persons (such as trade secrets, lists of customers and suppliers, research and development information) and may either belong to the debtor or to a third party, but be in the control of the debtor. It is desirable that an insolvency law includes provisions to protect these types of information from abuse by creditors or other parties who are in a position to take advantage of it in insolvency. In order to balance the debtor's obligation of protection against its obligation to provide information to the insolvency representative, the court or to creditors, the obligation to observe confidentiality and protect this information may also need to apply to parties connected to the debtor, the insolvency representative, creditors generally, creditor committees and third parties.

**(d) Ancillary obligations**

388. A number of insolvency laws impose additional obligations that are ancillary to the debtor's obligation to cooperate and assist. These may include, for example, an obligation (applying either to a natural person debtor or the managers and directors of a legal person debtor) not to leave their habitual place of residence without the permission of the court or the insolvency representative or to provide



notice to the court or the insolvency representative if they propose or are forced to leave that residence, to disclose all correspondence to the insolvency representative or the court and other limitations touching upon personal freedom. In the case of a legal person debtor, limitations may also apply to movement of the headquarters of that legal person and the insolvency law may require consent of the court or the insolvency representative. These limitations may be crucial to avoid disruption to the insolvency proceedings by the common practice of debtors leaving the place of business and of directors and managers resigning from office upon commencement. Where they are included in an insolvency law, it is desirable that these ancillary duties be proportionate to their underlying purpose and to the overall purpose of the general duty to cooperate; they may also be limited by the application of relevant human rights conventions and agreements as noted above.

389. Some insolvency laws specify these obligations as automatically applicable, while others provide that they may be applied at the discretion of the court where they are determined to be necessary for the administration of the estate. Some laws also distinguish between natural and legal person debtors; where the debtor is a natural person, limitations will only apply by order of the court, but where the debtor is a legal person, some limitations may apply automatically, such as the requirement to disclose correspondence.

**(e) Employment of professionals to assist the debtor**

390. To assist the debtor in carrying out its duties in relation to the proceedings generally, some insolvency laws permit the debtor to employ professionals such as accountants, attorneys, appraisers and other professionals as may be necessary, subject to authorization. In some laws, that authorization is provided by the insolvency representative, in other laws by the court or the creditors.

**(f) Failure to observe obligations**

391. Where the debtor fails to comply with its obligations, the insolvency law may need to consider how that failure should be treated, taking into account the different nature of obligations and appropriate sanctions. As noted above, where information is withheld by the debtor, a mechanism to compel the provision of relevant information such as a “public examination” of the debtor by the court or the insolvency representative may be appropriate. In more serious cases of withholding of information a number of countries impose criminal sanctions. Similar approaches may be appropriate for the breach of other obligations. In reorganization, conversion to liquidation (see chapter IV.A.14) may be an appropriate sanction, provided it is in the best interests of creditors; there will be cases where continuation of the reorganization, notwithstanding the debtor’s failure to cooperate or to otherwise observe its obligations, will be in the best interests of creditors.

392. The insolvency law may also need to consider the consequences of actions taken in violation of the obligations and whether or not those actions should be invalid. For example, contracts entered into by the debtor after the commencement of proceedings might be addressed in the context of avoidance proceedings or as unauthorised transactions. Consideration may also need to be given to the parties to whom the sanctions should apply in the case of a legal person debtor for example, any person who generally might be described as being in control of the debtor, including directors and management.

## 5. Debtor's liability

393. When the business entity is solvent, the debtor generally owes its principal obligation to the owners of the business, and its relations with its creditors will be governed by their contractual agreements. When the business becomes insolvent, however, the focus changes and the creditors become the real financial stakeholders in the business, bearing the risk of any loss suffered as the debtor continues to trade. Notwithstanding this change of focus, the conduct and behaviour of owners and management of a business is primarily a matter of law and policy outside the insolvency regime. It is not desirable that an insolvency law is used to remedy defects in that area of legal regulation or to police corporate governance policies, although some insolvency laws might include an obligation to commence insolvency proceedings at an early stage of financial difficulty (see chapter I.B). If the consequence of the past conduct and behaviour of persons connected with an insolvent debtor is damage or loss to the creditors of the debtor (for example, by fraud or irresponsible behaviour), it may be appropriate, depending upon the liability regimes applicable for fraud on the one hand and negligence on the other, for an insolvency law to provide for possible recovery of the damage or loss from the persons concerned.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions concerning the debtor is to:

- (a) establish the rights and obligations of the debtor during the insolvency proceedings;
- (b) address the remedies for failure of the debtor to meet its obligations;
- (c) address issues relating to management of the debtor in insolvency proceedings.

### Content of legislative provisions

#### *Rights*

- *Right to be heard (see recommendation (121))*
- *Right to participate and request information*

(93) The law should specify that the debtor is entitled to participate in the insolvency proceedings, and to obtain information relating to the insolvency proceedings from the insolvency representative and the court.

- *Right to retain property to preserve the personal rights of the debtor*

(94) Where the debtor is a natural person, the law should specify that the debtor is entitled to retain those assets excluded from the estate by the law.<sup>79</sup>

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<sup>79</sup> See chapter II.A.

*Obligations*

(95) The law should clearly specify the debtor's obligations in respect of insolvency proceedings, which obligations should arise on the commencement of, and continue throughout, those proceedings. The obligations should include:

(a) to cooperate with and assist the insolvency representative to perform its duties;

(b) to provide accurate, reliable and complete information relating to its financial position and business affairs that [reasonably] might be requested by the court, the insolvency representative, creditors and/or the creditor committee, including lists of:<sup>80</sup>

(i) transactions occurring prior to commencement that involved the debtor or the assets of the debtor;

(ii) ongoing court, arbitration or administrative proceedings, including enforcement proceedings;

(iii) assets, liabilities, income and disbursements;

(iv) debtors and their obligations;

(v) creditors and their claims in cooperation with the insolvency representative and to revise and amend the list as claims are verified and admitted or denied;

(c) [where an insolvency representative is appointed] to enable the insolvency representative to take effective control of the estate and to facilitate or cooperate in the recovery by the insolvency representative of the assets, or control of the assets of the estate, wherever located<sup>81</sup> and business records;

(d) where the debtor is a natural person, to provide notice to the court if it proposes or is forced to leave its habitual place of residence and, where the debtor is a legal person, to obtain the consent of the court or the insolvency representative to the movement of the headquarters of the debtor.

*Confidentiality*

(96) The law should specify protections for information provided by the debtor<sup>82</sup> that is commercially sensitive or confidential.

*The debtor's role in continuation of the business*

(97) The law should specify the role of the debtor in the continuing operation of the business during insolvency proceedings. Different approaches may be taken, including:

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<sup>80</sup> Subject to allowing the debtor the time necessary to collect the relevant information.

<sup>81</sup> See chapter VII—the Model Law on Cross-Border Insolvency and appointment of a foreign representative.

<sup>82</sup> Information provided by the debtor may include information in control of the debtor, owned by the debtor or a third party.

(a) retention of full control of the business (debtor-in-possession), with appropriate protections including varying levels of control of the debtor and provision for displacement of the debtor in specified circumstances;<sup>83</sup>

(b) limited displacement where the debtor may continue to operate the business on a day-to-day basis, subject to the supervision of an insolvency representative, in which event the division of responsibilities between the debtor and the insolvency representative should be specified in the law; or

(c) total displacement of the debtor from any role in the business and the appointment of an insolvency representative.

*Sanctions for failure to comply*

(98) The law should permit the imposition of sanctions for the failure of the debtor to comply with its obligations under the law.

## **B. The insolvency representative**

### **1. Introduction**

394. Insolvency laws refer to the person responsible for administering the insolvency proceedings by a number of different titles, including administrators, trustees, liquidators, supervisors, receivers, curators, official or judicial managers, or commissioners. The term “insolvency representative” is used in this Guide to refer to the person undertaking the range of functions that may be performed in a broad sense without distinguishing between the different functions that may be performed in different types of proceedings. The insolvency representative may be an individual or, in some jurisdictions, a corporation or other separate legal entity. However appointed the insolvency representative plays a central role in the effective and efficient implementation of the insolvency law, with certain powers over debtors and their assets, a duty to protect those assets and their value, as well as the interests of creditors and employees, and to ensure that the law is applied effectively and impartially. Accordingly it is essential that the insolvency representative be appropriately qualified and possess the knowledge, experience and personal qualities that will ensure not only the effective and efficient conduct of the proceedings and but also that there is confidence in the insolvency system.

### **2. Qualifications**

395. The qualifications required of a person who can be appointed as an insolvency representative may vary depending upon the design of the insolvency regime with regard to the role of the insolvency representative (including whether the proceedings are liquidation or reorganization) and the level of supervision of the insolvency representative (and of the insolvency proceedings generally) by the court. They may also vary depending upon the procedure for appointment (see below). Where the insolvency law provides for the appointment of a public official as insolvency representative, the specific qualifications discussed below generally will

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<sup>83</sup> It should be noted that this option relies on a well-developed court structure and the application of protections that operate to displace the debtor in certain circumstances. For a more detailed explanation see chapter III.A.2 (b) (ii).

not be relevant to that appointment (although they may be relevant to the employment of the official by the government agency).

396. In determining the qualifications required for appointment as an insolvency representative, it is desirable that a balance be achieved between stringent requirements that lead to the appointment of a highly qualified person but which may significantly restrict the pool of professionals considered to be appropriately qualified and add to the costs of the proceedings, and requirements that are too low to guarantee the quality of the service required. Where there is a lack of appropriately qualified professionals, the role given to the court in appointment and supervision of the insolvency representative may be an important factor in achieving the required balance.

**(a) Interim insolvency representative**

397. Where an insolvency representative is appointed on an interim basis by the court before insolvency proceedings commence, the powers and functions of that person generally will be determined by the court. To the extent that they are the same as those of an insolvency representative appointed after commencement of proceedings, the interim insolvency representative should have the same qualifications, as well as liability and rates of remuneration as a representative appointed after commencement.

**(b) Knowledge and experience**

398. The complexity of many insolvency proceedings makes it highly desirable that the insolvency representative be appropriately qualified with knowledge of the law (not only insolvency law, but also relevant commercial, finance and business law), as well as adequate experience in commercial and financial matters, including accounting. The insolvency representative will be required to demonstrate competence in carrying out its assigned functions in a range of different cases and circumstances that are likely to be contentious, in both liquidation and reorganization, where time limits may be imposed by the insolvency law, where commercial requirements have to be balanced against legal considerations, and where there is a need to serve the interests of others, such as creditors and maybe a public interest. If further or more specialized knowledge is required in a particular case, it can always be provided by hired experts. Some insolvency laws also require that a person to be appointed as an insolvency representative in a particular case have expertise and skills suited to that case, such as knowledge of the debtor's particular business, its assets and the type of market in which it operates.

**(c) Ensuring appropriate qualifications**

399. Different approaches are taken to ensuring the appropriate qualification of the insolvency representative, including a requirement for certain professional qualifications and examinations; licensing where the licensing system is administered by a government authority or professional body; specialised training courses and certification examinations; requirements for certain levels of experience (generally specified in numbers of years) in relevant areas, for example, finance, commerce, accounting and law, as well as in the conduct of insolvency proceedings. There may also be requirements for ongoing professional education to ensure familiarity with current developments in relevant areas of law and practice. Those

systems which require some form of licensing or professional qualification and membership of professional associations often also address issues of supervision and discipline, and an insolvency representative may be subject to regulation by the court, a professional association, a corporate regulator or other body, under legislation other than the insolvency law. A number of these systems are relatively complex and it is beyond the scope of the Guide to consider them in any detail.

**(d) Personal qualities**

400. In addition to having the requisite knowledge and experience, it may also be desirable that the insolvency representative possesses certain personal qualities, such as integrity, impartiality and good management. Integrity may require that the insolvency representative have a sound reputation and no criminal record or record of financial wrongdoing, or in some countries, no previous insolvency or removal from a position of public administration. The occurrence of such an event generally would be sufficient to disqualify the proposed appointee from appointment.

**(e) Conflicts of interest**

401. An essential element of these qualities is that the insolvency representative be able to demonstrate independence from vested interests, whether of an economic, familial or other nature. To that end, it is desirable that the insolvency law impose an obligation to disclose existing or potential conflicts of interest, which would apply to a person proposed for appointment as an insolvency representative at the commencement of the proceedings and to the appointed person on a continuing basis throughout the proceedings. The law should specify to whom the disclosure should be made which may vary depending upon the procedure for selection and appointment of the insolvency representative. The circumstances that amount to a conflict of interest vary between laws, as do the consequences of a conflict being disclosed at the commencement of proceedings or discovered at some later stage.

402. A conflict of interest may arise, for example, from a number of prior or existing relationships with the debtor. Prior ownership of the debtor, a prior or existing business relationship with the debtor (including being a party to a transaction with the debtor that may be subject to investigation in the insolvency proceedings and being a creditor or debtor of the debtor), a relationship with a creditor of the debtor, prior engagement as a representative or officer of the debtor, and a relationship with a competitor of the debtor may be sufficient to establish a conflict of interest. In some countries that conflict of interest will preclude the appointment of the person as an insolvency representative, or disqualify an appointee from continuing in that role. In other countries, the person may still be appointed provided the conflict of interest is disclosed on the basis that the disclosure supports their integrity and any impartiality or lack of independence can be assessed against the circumstances disclosed. In order to enhance the transparency, predictability and integrity of the insolvency system, it is desirable that the insolvency law specify the degree of relationship which may give rise to such a conflict of interest. It is generally left to the courts to determine whether or not a conflict of interest or a basis for demonstrating lack of independence exists in a particular case.

### **3. Selection and appointment of the insolvency representative**

403. Insolvency laws adopt a number of different approaches to selection and appointment of an insolvency representative. The insolvency representative can be selected from a number of different backgrounds such as from the ranks of the business community, from the employees of a specialized governmental agency or from a private panel of qualified persons (often lawyers, accountants or other professionals). In some jurisdictions, the insolvency law provides that a particular public official (variously titled the Official Trustee, the Official Receiver, the Official Assignee) automatically will be appointed to all insolvency cases or to certain types of insolvency cases. In many countries, the insolvency representative must be a natural person, but some countries do provide that a legal person may also be eligible for appointment, subject to certain requirements such as that the individuals to undertake the work on behalf of the legal person are appropriately qualified and that the legal person itself is subject to regulation.

#### **(a) Court selection and appointment**

404. In many jurisdictions, it is the court that selects, appoints and supervises the insolvency representative. The selection may be made from a list of appropriately qualified professionals at the discretion of the court, it may be made by reference to a roster or rotation system or by some other means, such as the recommendation of the creditors or the debtor. While ensuring fair and impartial distribution of cases, one possible disadvantage of a roster system is that it may not ensure the appointment of the person most qualified to conduct the particular case. That may depend, of course, upon the manner in which the roster list is compiled and upon the qualifications required of insolvency professionals in order to be included on that list. That disadvantage may not be perceived to be an important issue where the estate does not have sufficient assets to fund the cost of the administration.

#### **(b) Independent appointing authorities**

405. In some jurisdictions, a separate office or institution which is charged with the general regulation of all insolvency representatives selects the insolvency representative after the court directs it to do so. This approach may have the advantage of allowing the independent appointing authority to draw upon professionals that will have the expertise and knowledge to deal with the circumstances of a particular case, including the nature of the debtor's business or other activities; the type of assets; the market in which the debtor operates or has operated; the special knowledge required to understand the debtor's affairs; or some other special circumstance. The use of an independent appointing authority will depend upon the existence of an appropriate body or institution that has both the resources and infrastructure necessary to perform the required functions; otherwise it will require the establishment of an appropriate body or institution.

#### **(c) Role of creditors**

406. Another approach allows creditors to play a role in recommending and selecting the insolvency representative to be appointed, provided that that person meets the qualifications for serving in the specific case. The approaches that rely upon the independent appointing authority and the creditor committee may serve to avoid perceptions of bias and assist in reducing the supervisory burden placed upon

the courts. A different approach permits the debtor to appoint the insolvency representative in those cases where reorganization proceedings are commenced by the debtor. This approach allows discussions to take place between the debtor and other parties, such as secured creditors, before commencement of the proceedings to familiarise the prospective representative with the business and allows the debtor to select an insolvency representative that it considers will be best able to conduct the reorganization. Concerns may be raised, however, as to the independence of the insolvency representative. These may be addressed by permitting creditors, in appropriate circumstances, to replace an insolvency representative appointed by the debtor.

#### **4. Oversight of the insolvency representative**

407. In addition to the requirements for qualifications and personal qualities applicable on appointment, oversight of the insolvency representative's performance of its functions (and its demonstration of the qualities indicated above), can occur in respect of individual cases through the design of the insolvency law and the respective roles assigned to participants. [232] Insolvency laws adopt a variety of approaches, for example, to the relationship between the insolvency representative and the court and, in particular, to the delineation of powers between them, as well as to the role that creditors might play in overseeing certain decisions of the insolvency representative and on other issues, such as remuneration and even removal from office. Since it normally has the most information regarding the situation of the debtor, the insolvency representative often is in the best position to make informed decisions about the conduct of the insolvency proceedings. That does not mean, however, that the insolvency representative can act as a substitute for the court. Notice may be required to be given to the court or to creditors before the insolvency representative takes certain decisions, the insolvency representative may be required to report to the court and to creditors on a regular basis or in respect of certain activities, the court would generally be required to adjudicate disputes arising in the conduct of the proceedings and its approval is often required at a number of stages of the proceedings. Even in countries where the court plays a more limited role in insolvency, there is a limit to the amount of authority that would normally be conferred upon an insolvency representative.

#### **5. Duties and functions of the insolvency representative**

408. Insolvency laws often specify the duties and functions that the insolvency representative will have to perform in the proceedings and it is important that the insolvency law provide the insolvency representative with the powers necessary to carry out these duties and functions efficiently and effectively. Although some of those noted below may be more relevant to liquidation than to reorganization, the insolvency representative's duties and functions with respect to the administration of the proceedings and preservation and protection of the estate may generally include those set out below. This list is not intended to be exhaustive and in some cases the different functions will overlap or may not be relevant because of the design of the insolvency law.

- (i) taking immediate control of the assets comprising the insolvency estate and the debtor's business records;
- (ii) representing the insolvency estate;



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- (iii) obtaining post-commencement finance;
  - (iv) exercising rights for the benefit of the insolvency estate in respect of court, arbitration or administration proceedings underway;
  - (v) taking all steps necessary to protect and preserve the assets of the insolvency estate and the debtor's business, including preventing unauthorised disposal of those assets and exercising avoidance powers to pursue the recovery of assets disposed of improperly to defeat creditors;
  - (vi) registering rights of the estate (where registration is necessary to perfect the rights of the estate against bona fide purchasers);
  - (vii) appointing and remunerating accountants, attorneys and other professionals that may be necessary to assist the insolvency representative in performing its functions;
  - (viii) obtaining information concerning the debtor, its assets, liabilities and past transactions (especially those taking place during the suspect period) including examining the debtor and any third person having had dealings with the debtor ;
  - (ix) examination of contracts that are not fully performed with a view to deciding whether to continue performance or reject;
  - (x) dealing with employees and their rights and entitlements, including pension rights;
  - (xi) in liquidation, realizing the assets of the insolvency estate;
  - (xii) verifying and admitting claims and maintaining an updated list of claims verified and admitted;
  - (xiii) periodically providing information to the court and to creditors detailing the conduct of the proceedings. The information should include, for example, details of the assets sold during the period in question, the prices realized, the expenses of sale and such information as the court may require or the creditors' committee may reasonably require; receipts and disbursements; assets remaining to be administered;;
  - (xiv) attending meetings of creditors;
  - (xv) managing the business in reorganization and in liquidation where the business is to be sold as a going concern;
  - (xvi) in reorganization, preparing or assisting to prepare a plan of reorganization or a report as to why reorganization is not possible (where this function is to be carried out by the insolvency representative);
  - (xvii) supervising approval of the reorganization plan and, where required, the implementation of the plan;
  - (xviii) distributing the proceeds of realization of the estate in liquidation and closing the estate promptly, efficiently and in accordance with the best interests of the various constituencies in the case;
  - (xix) submitting a final report and accounting of the insolvency estate's administration to the court or the creditors, as required;

(xx) any other matters that may be referred to the insolvency representative by the creditors or determined by the court.

409. In addition to these specific duties and functions, insolvency laws often impose certain general obligations on the insolvency representative. These may include an obligation to maximize the value and protect the security of the insolvency estate, and a duty to get the best price reasonably obtainable on the sale of assets of the estate.

410. Where reorganization involves a debtor-in-possession and no insolvency representative is appointed, many of these functions will be performed by the debtor, with varying degrees of supervision by the court or by creditors.

## **6. Confidentiality**

411. The need to impose an obligation of confidentiality on the debtor has been noted above. It may also be appropriate for the insolvency law to impose a duty of confidentiality on the insolvency representative as much of the information that will be obtained concerning the debtor's affairs will be of a commercially sensitive nature, confidential or subject to obligations owed to other persons (such as trade secrets, research and development information and customer information) and should not be disclosed to third parties who may be in a position to take unfair advantage of it. Where the information is to be disclosed to creditors, those creditors should be under the same obligation of confidentiality as the insolvency representative. Observation of confidentiality may be particularly important where the insolvency representative has the power to compel disclosure of information and documents in the course of an examination of the debtor. Some of this information may come from third parties and be subject to privacy protection provisions and secrecy provisions, such as those applicable to banks. It is desirable that the insolvency representative be permitted to use that information only for the purposes of the insolvency proceedings in the context of which the examination was permitted, unless the court decides otherwise. This issue may also be relevant to the provision and obtaining of information in the context of criminal proceedings against the debtor. A similar obligation of confidentiality should apply to agents and employees of the insolvency representative (see section 8 below) and to other parties as ordered by the court.

## **7. Remuneration of the insolvency representative**

### **(a) Determination of quantum**

412. In addition to the reimbursement of the proper expenses incurred in the course of administration of the estate, the insolvency representative will be entitled to receive remuneration for its services. That remuneration should be commensurate with the qualifications of the insolvency representative and the tasks it is required to perform, and achieve a balance between risk and reward in order to attract appropriately qualified professionals. Several methods are adopted for calculating that remuneration. It may be fixed by reference to an approved scale of fees set by a government agency or professional association; determined by the general body of creditors, the court or some other administrative body or tribunal in a particular case; based upon the time properly spent by the insolvency representative (and the various categories of person who are likely to work on the insolvency

administration from office staff through to the principal appointee) on administration of the estate; or it could be based upon a percentage of the quantum of the assets of the estate which are realized or distributed or a combination of both (calculated at the end of the procedure when the assets have been sold and the value determined). This may be a fixed percentage and include provision for increase or decrease depending upon the particular case. In each of these cases, the insolvency law generally makes provision for further investigation upon the application either of a party, a third person or the insolvency representative itself, depending upon the method of calculation. Such an approach will be important to ensure transparency. At the same time, however, it is important to avoid a situation where the party with the right of final determination can thus influence the conduct of the proceedings.

(i) *Time-based systems*

413. An advantage of a time-based method is that often there will be a high level of uncertainty at the outset as to how complex and resource-intensive a particular administration may be, at least until some preliminary work has been carried out. A disadvantage is that although it may encourage a very thorough administration, a time-based system may also operate in some cases as an incentive to maximise the time spent on administration without necessarily achieving a proportional return of value to the estate.

(ii) *Commission-based systems*

414. An advantage of the commission system, at least from the creditors' perspective, is that at least some, if not a substantial proportion, of the assets recovered will be distributed to them. From the insolvency representative's point of view, however, it may be an uncertain method of calculation because the amount of work involved in an administration is not necessarily proportional to the value of assets available for distribution. It may also encourage an approach of "maximum return for minimum cost" and provides little incentive for undertaking functions which are not directly related to increasing returns to creditors, such as obligations to report to both the court and to creditors, and to assist regulatory authorities with investigations into the debtor's affairs and possible misconduct. This method of calculation may also lead, in very large cases, to significantly large fees being paid out of the estate, which can deter both creditor and debtor applications.

(iii) *Involvement of creditors*

415. In some countries, the creditors (or the creditor committee) may be required to play a role in fixing or approving the remuneration, having regard to factors such as the complexity of the case, the nature and degree of the responsibilities of the insolvency representative and the effectiveness with which these have been discharged, as well as the value and nature of the assets of the estate. The involvement of creditors may serve to overcome some of the difficulties discussed above as creditors would be more aware of the issues involved and have the opportunity to participate in remuneration setting and approval. Remuneration could also be reviewed periodically during the course of the proceedings, with any problems arising being addressed and resolved, perhaps by arbitration or some other form of dispute resolution between the insolvency representative and the creditors.

416. It is highly desirable that the insolvency law establish a mechanism for fixing the insolvency representative's remuneration that is clear and transparent to avoid disputes and to provide some level of certainty as to the costs of insolvency proceedings. However calculated, it is also desirable that an insolvency law recognizes the importance of according priority to payment of the insolvency representative's remuneration.

**(b) Means of payment**

417. Payment of the remuneration of the insolvency representative is often a source of complaint from unsecured creditors; the most common source of available funds is often unencumbered assets and payment may result in nothing being left for distribution to those creditors. While it would be unfair to draw the conclusion that the costs of administration were excessive simply because they exceeded the unencumbered assets available to pay them, the occurrence of unsecured creditors seeing most, if not all of the available assets being used to cover the costs of the administration, and perceptions of unfairness relating to the total cost of administration compared to the value of assets recovered, do point to the need to give this issue careful consideration. Different approaches can be taken to payment of the insolvency representative. For example, where the estate includes unencumbered assets, remuneration could be paid from these; a surcharge could be levied against assets to pay for the administration or sale of those assets where the administration or sale was of benefit to the creditors; a surcharge also could be levied on creditors making an application to cover at least initial costs and performance of basic functions; or encumbered assets may be subject to payment of a proportionate or defined share of remuneration (see chapter VI Priorities). Another approach is to pay the insolvency representative from a fund maintained for that purpose by the State, an approach that may be particularly relevant in the case of debtors with insufficient assets to pay for administration of the estate (see chapter I.B.6).<sup>84</sup>

**(c) Review of remuneration**

418. Depending upon the manner in which the insolvency representative's remuneration is fixed, it may be desirable to provide for a review process to address dissatisfaction of the insolvency representative itself or of creditors. Where remuneration is fixed by a meeting of creditors, the court will generally have the power to review the amount on the application of the insolvency representative or of a specified percentage or number of creditors, for example creditors representing 10 per cent of the issued share capital or with at least 10 per cent or 25 percent of the total debts. Where the remuneration is set by the court in the first instance, different approaches are taken; some laws permit the insolvency representative to appeal that decision, other laws do not. Some insolvency laws also provide that the debtor cannot make an application for review. Where the insolvency representative is required to be a member of a professional organization or to be licensed, the professional organization or the licensing authority may also have powers with respect to review of the fees charged by their members and may provide informal dispute resolution mechanisms.

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<sup>84</sup> Such a fund may be financed by a number of means, for example payments by the directors of debtors being liquidated, increased filing fees for insolvency applications, requiring all monies realized in liquidation to be deposited into a common account, with interest going to the fund, levies on lodgement of annual corporate returns.

## 8. Liability of the insolvency representative

419. The standard of care to be employed by the insolvency representative and its personal liability are important to the conduct of insolvency proceedings. Establishing a measure for the care, diligence and skill with which the insolvency representative is to carry out its duties and functions requires that the difficult circumstances in which the insolvency representative finds itself when fulfilling its duties are taken into account and balanced against payment of an appropriate level of remuneration and the need to attract qualified persons to act as insolvency representatives. A balance is also desirable between a standard that will ensure competent performance of the duties of the insolvency representative and one that is so stringent it invites law suits against the insolvency representative and raises the costs of its services. The insolvency law will also need to take into consideration the fact that the liability of the insolvency representative may often involve the application of law outside of insolvency, or where the insolvency representative is a member of a professional organization, the relevant professional standards of the organization.

420. Under many legal systems, the insolvency representative will be liable in a civil action for damages arising from its misfeasance or malfeasance, although different approaches are taken to setting the standard required. To some extent, the measure adopted will depend upon the how the insolvency representative is appointed and the nature of the appointment (e.g. a private practitioner as opposed to a government employee). One approach may be to require the insolvency representative to observe a standard no more stringent than would be expected to apply to the debtor in undertaking its normal business activities in a state of solvency, that of a prudent person in that position. Some countries, however, may require a higher standard of prudence in such a case because the insolvency representative is dealing with assets belonging to another person, not its own assets. A different formulation is one based upon an expectation that the insolvency representative act in good faith for proper purposes. A further approach may be based upon the standard of care required to determine negligence.

421. One means of addressing the issue of liability for damages may be to require the insolvency representative to post a bond or take out insurance to cover loss of assets of the estate or possible damages payable as a result of a breach of its duties. A number of insolvency laws require both payment of a bond and insurance where the bond will cover one kind of damage and the insurance another, while others require only insurance. In some cases the level of the bond required relates to the book value of the assets of the insolvency estate, in others both the value of the bond and the amount of insurance cover required are established in the rules of the relevant professional association or regulatory body, or even in the insolvency law. A further distinction between the two approaches may relate to the procedure for making a claim for damages and whether it is different for claiming against a bond or against insurance. Paying a bond or obtaining personal indemnity insurance however, may not be possible in all countries and other solutions will be needed. In designing the solution to this issue, a balance may be desirable between controlling the costs of the service provided by insolvency representatives and distributing the risks of the insolvency process among the participants, rather than placing it entirely upon the insolvency representative on the basis of availability of personal indemnity insurance.

422. Another issue may be the personal liability of the insolvency representative for obligations incurred in the ordinary course of insolvency proceedings, particularly in reorganization, such as those relating to the ongoing operation of the business. The advantages of adopting an approach that makes the insolvency representative personally liable would be that it creates certainty for suppliers to the debtor and may operate as a check to the incurring of debt. At the same time, however, it may also operate as a disincentive if the risk of personal liability far exceeds the fees that may be earned. One solution is to make only the assets of the estate liable, rather than the personal assets of the insolvency representative.

423. A further issue of liability relates to liability of the insolvency representative for wrongful acts of the debtor depending upon the level of control the insolvency representative exercises over the debtor's activities. Under some laws the insolvency representative may be made liable for the wrongful acts of the debtor during the period of its control, but it is not desirable that the insolvency representative be liable for acts of the debtor, such as environmental damage, occurring prior to its appointment as insolvency representative.

424. Where an action is commenced against the insolvency representative in its official capacity, consideration may need to be given to determining which court will have jurisdiction over the action. To avoid uncertainty and confusion, it may be desirable to ensure that it is the same court that appointed the insolvency representative (where the court plays a role in such appointment).

## **9. Agents and employees of the insolvency representative**

425. Some insolvency laws require court authorization for the insolvency representative to retain accountants, attorneys, appraisers and other professionals that may be necessary to assist the insolvency representative in carrying out its duties. Other laws do not require court authorization. It is desirable that an insolvency law establishes some criteria relating to the employment of such professionals in terms of their experience, knowledge and reputation, as well as the need for their services to be of benefit to the estate. The requirements for disclosure of conflicts of interest or circumstance giving rise to a lack of independence that apply to the insolvency representative are also relevant to professionals employed or proposed for employment by the insolvency representative, as are obligations of confidentiality.

### **(a) Liability for acts or omissions**

426. Where losses are sustained by the estate as a result of the actions of agents and employees of the insolvency representative, an insolvency law may need to address the liability of the insolvency representative for those actions. Some insolvency laws provide that the insolvency representative is not personally liable except where it fails to exercise the proper degree of supervision in the performance of its duties.

### **(b) Remuneration**

427. Different approaches may be adopted towards payment of the professionals employed by the insolvency representative. Some laws require an application to and approval by the court of the amount of the remuneration, while another approach may be to require approval by the creditor body. Professionals may be paid periodically during the proceedings, or may be required to wait until the

proceedings are completed. In terms of how they are to be paid, some insolvency laws provide that the insolvency representative will pay the professional and seek reimbursement from the estate, while under other laws the professional will have an administrative claim against the estate.

#### **10. Review of insolvency representative's administration**

428. The grounds upon which creditors may question either the decisions or administration of an insolvency representative and the decisions that may be subject to such questioning should be expressly stated in an insolvency law. The grounds for creditor action under existing laws can be divided into two main categories.

429. In the first category are those laws under which creditors are given certain rights where the insolvency representative can be shown to have committed some wrong. That wrong may include actual wrongdoing, such as the misappropriation of funds or assets or obtaining creditors' approval by improper means; procedural errors, such as a failure to seek a necessary approval of creditors or a creditors committee, or to undertake another act required by law; or negligence by the insolvency representative in the performance of its duties. Some jurisdictions limit a creditor's right to challenge the insolvency representative to some, if not all, of these situations.

430. In the second category are those laws which provide, normally in addition to the grounds related to specific wrongdoing, that creditors can test (typically in the courts) any decision, act or omission of the insolvency representative which they individually or collectively object to or disapprove of. The basis of a successful action will normally be grounds similar to those already mentioned above, but may also include proof that the decision, act or omission was contrary to the interests of creditors. To prevent unreasonable disruption of the administration of an estate, an insolvency law may adopt appropriate limitations such as adjusting the standard of proof to be met in order for the court to uphold the creditors' appeal or protecting certain aspects of an administration against appeal, e.g. excluding actions concerning commencement of insolvency proceedings.

431. Most laws provide the courts, in reviewing an insolvency administration and enforcing the substantive rights of creditors, a number of powers. At one level, a court may direct an insolvency representative to take, or refrain from taking, a particular action related to the creditor's objection. The court may also have powers to confirm, reverse or modify decisions of the insolvency representative or to remove the insolvency representative whether at the direct request of the objecting creditor or on the motion of the court (see chapter IV.B.9). Many insolvency laws provide that the insolvency representative is personally liable for damages intentionally or negligently caused to creditors through the performance of the insolvency representative's duties. Some insolvency laws also provide that in those circumstances the court may impose a monetary penalty on the insolvency representative.

#### **11. Removal of the insolvency representative**

432. Some insolvency laws permit the insolvency representative to be removed in certain circumstances which may include that the insolvency representative had violated or failed to comply with its legal duties under the insolvency law; had demonstrated gross incompetence or gross negligence; had not disclosed a conflict of interest; had engaged in illegal conduct; or for less serious reasons such as that

the proceedings require a particular or different competency that the appointed representative does not possess. The latter may occur, for example, where the proceedings are converted from liquidation to reorganization, which requires skills the insolvency representative may not have or, in the case of a debtor-in-possession reorganization, which do not require an insolvency representative to be appointed. Different approaches provide that removal may occur on the basis of a decision of the court, acting on its own motion or at the request of an interested party, or a decision taken by an appropriate majority of unsecured creditors. Whichever approach is adopted, removal operates as a sanction against the insolvency representative and it is therefore appropriate that the insolvency representative have the right to be heard and to present its case. In cases where the insolvency representative is subject to professional or regulatory supervision, they may be removed as the result of an investigation and review, which may also result in a licence or other authorization being taken away.

## 12. Replacement of the insolvency representative

433. In the event of the resignation or removal of the insolvency representative or the occurrence of any other event which might cause the insolvency representative to be unable to perform its duties, such as death or serious illness, disruption of the proceedings and the delay that may be occasioned by failure to provide for succession may be avoided by providing for the appointment of a successor insolvency representative, either by the court or by creditors. Some insolvency laws require the courts also to approve the resignation of the insolvency representative, while other laws do not. Where an insolvency law provides for replacement of the insolvency representative, it may also need to address issues relating to substitution and succession to either title or control (as appropriate) of the assets of the estate (see chapter II.A) as well as handing over to the successor the books, records and other information relating to the debtor. An insolvency law may also need to consider the issue of the validity of the acts undertaken in the conduct of the proceedings by the insolvency representative that has been replaced.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions concerning the insolvency representative is to:

- (a) specify qualifications required for appointment ;
- (b) establish a mechanism for selection and appointment;
- (c) specify powers and functions ;
- (d) provide for remuneration, liability, removal and replacement.

### Contents of legislative provisions

#### *Qualifications*

(99) The law should specify the qualifications and qualities required for appointment as an insolvency representative, including integrity, independence, impartiality, requisite knowledge of relevant commercial law and experience in



commercial and business matters. The law should also specify the grounds upon which a proposed insolvency representative may be disqualified from appointment.

#### *Conflict of interest*

(100) The law should require the disclosure of a conflict of interest, a lack of independence or circumstances that may lead to a conflict of interest or lack of independence by:

(a) a person proposed for appointment as an insolvency representative ;

(b) persons proposed for employment by the insolvency representative or the estate including professionals.

(101) The law should specify that the obligation to disclose set forth in recommendation (100) should continue throughout the insolvency proceedings. The law should specify the consequences of a conflict of interest or lack of independence.

#### *Appointment*

(102) The law should establish a mechanism for selection and appointment of an insolvency representative. Different approaches may be taken, including appointment by the court; by an independent appointing authority; on the basis of a recommendation by creditors or the creditor committee; by the debtor; or by operation of law, where the insolvency representative is a government or administrative agency or official.

#### *Remuneration*

(103) The law should establish a mechanism for fixing the remuneration of the insolvency representative and establish priority for payment of that remuneration.

#### *Duties and functions of the insolvency representative*

(104) The law should specify that the insolvency representative has an obligation to protect and preserve the assets of the estate. The law should specify the insolvency representative's duties and functions with respect to the administration of the proceedings and preservation and protection of the estate.

#### *Right to be heard (see recommendation (121))*

#### *Liability*

(105) The law should specify the consequences of the insolvency representative's failure to perform, or to properly perform, its duties and functions under the law and the possible liability arising in each instance..

#### *Removal and replacement*

(106) The law should establish the grounds and procedure for removal of the insolvency representative. The grounds may include:

(a) incompetence, failure to perform or failure to exercise the proper degree of care in the performance of its powers and functions;

- (b) inability to perform;
  - (c) lack of a particular or specialized qualification required by a specific case;
  - (d) engaging in illegal acts or conduct;
  - (e) conflict of interest or a lack of independence that would justify removal;
- or
- (f) where the function of the insolvency representative changes.<sup>85</sup>

(107) The law should establish a mechanism for removal of the insolvency representative that reflects the manner in which the insolvency representative was appointed and provides a right for the insolvency representative to be heard.

(108) In the event of the death, resignation, or removal of the insolvency representative, the law should establish a mechanism for appointment of a replacement and specify whether or not court approval of the replacement is necessary.

*Estates with insufficient assets to meet costs of administering insolvency proceedings*

(109) Where the law provides for appointment of an insolvency representative to administer an estate with insufficient assets to meet the costs of administering the insolvency proceedings, the law should also establish a mechanism for appointment and remuneration of that representative.

## C. Creditors—participation in insolvency proceedings

### 1. Introduction

434. Creditors have a significant interest in the debtor's business once insolvency proceedings are commenced. As a general proposition, these interests are safeguarded by the appointment of an insolvency representative, but for a number of different reasons, many insolvency laws provide for creditors to be directly involved in the proceedings. As the party with the primary economic stake in the outcome of the proceedings they may lose confidence in a process where key decisions are made without consulting them by individuals who may be perceived by creditors as having limited experience or expertise in the debtor's type of business or a lack of independence, depending upon the manner in which the representative is appointed. Creditors are often in a good position to provide advice and assistance with respect to the debtor's business and to monitor the actions of the insolvency representative, providing a check against possible abuse of the insolvency process and excessive administrative costs, as well as a means for processing and distributing information. Against the desirability of facilitating creditor participation must be balanced the need to ensure the creditor representation mechanism remains effective and cost-effective and avoids creditors involving themselves in matters that will not impact on their interests (although it may be difficult to draw a clear distinction between those matters that do have such an impact and those that do not).

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<sup>85</sup> Such as where the proceedings are converted from liquidation to reorganization.

435. Where the insolvency law does provide for creditors to participate in the proceedings, that participation may take different forms. Under some laws it includes only the right to be heard and to appear in the proceedings, while under others it also includes the right to vote on specified matters, the provision of advice to the insolvency representative as required or on specified matters, and other functions and duties as determined by the insolvency law, the courts or the insolvency representative.

## **2. Extent of involvement of creditors in the decision-making process**

### **(a) Levels of participation**

436. There are varying possible degrees of involvement of creditors in decision-making in insolvency proceedings and insolvency laws adopt a wide range of approaches and mechanisms for creditor participation. An approach which allows only a low level of participation is reflected in those insolvency laws which provide that the insolvency representative makes all key decisions on uncontested general matters of administration, with creditors playing a marginal role and having little influence. Lack of creditor participation in this model may be balanced against the key obligations of the insolvency representative one of which is to protect the value of the insolvency estate, ultimately for the benefit of creditors generally. Such an approach may be effective where an experienced insolvency representative is appointed to the proceedings because it avoids potential delays and the costs involved in managing the participation of creditors, and where the insolvency system provides a high level of regulation of the process and its participants.

437. Other approaches afford creditors greater participation in the proceedings. This participation may range from participation at an initial meeting where certain matters are considered, to an ongoing role which may require creditors to perform only an advisory function or to approve certain acts and decisions of the insolvency representative. These acts and decisions generally involve administration of the proceedings and issues which affect the interests of creditors and may include the sale of significant assets, verification of claims, approval of administrative expenses and remuneration of the insolvency representative and approval of the insolvency representative's final report and accounting on the estate, and even primary responsibility for carrying out some administrative functions. Creditors may also have functions with respect to selection and appointment of the insolvency representative, as well as being able to seek the dismissal and replacement of the insolvency representative by the court for failure to perform its functions and duties or for negligence. Creditors may also have a role in requesting or recommending action from the court, for example, a recommendation that the reorganization be converted to liquidation or that an avoidance action be commenced by the insolvency estate or by creditors on behalf of the estate. It should be noted, however, that in considering the extent of the powers to be given to creditors to object to acts or decisions of the insolvency representative some level of disagreement is almost impossible to avoid, particularly as the insolvency representative will be required to act for the benefit of all creditors and to take action that individual creditors may not support or agree with. In the normal course of events, however, such dissatisfaction would not give the court cause to replace the insolvency representative or give the creditor grounds for an action against the insolvency representative. To some extent, the different approaches reflect different insolvency

cultures and traditions and in particular, different expectations on the part of creditors as to their participation in insolvency proceedings. However creditor participation is increasingly regarded as an important element of an insolvency law, particularly as a balance to the roles assigned other participants under the law and as an important means of safeguarding creditor interests.

**(b) Participation in liquidation and reorganization**

438. Some insolvency laws draw a distinction between liquidation and reorganization in setting the level of creditor participation. In liquidation, although generally it may not be important for creditors to intervene in the process or participate in decision making, they can provide a valuable source of expert advice and information on the debtor's business, particularly where it is to be sold as a going concern. It may be desirable for creditors to receive reports on the conduct of the liquidation to ensure their confidence in the process, as well as its transparency. In reorganization, however, the input of creditors is both useful and necessary, as they will generally determine whether a proposed reorganization plan will be supported and its implementation successful.

**(c) Mechanisms to facilitate participation**

439. In terms of the mechanisms for participation, some insolvency laws provide for full meetings of creditors to be convened at key points of the proceedings, while other laws provide for the formation of a committee (on which creditors sometimes may share representation with shareholders and possibly other interested parties) comprising a small number of creditors (which number may be specified in the insolvency law) to facilitate the participation in the administration of the estate. The former approach is most useful in cases with small numbers of creditors or where creditors are located in the same geographical region. The latter may be more useful where there are large numbers of creditors or creditors are located in different regions or even countries. Where a committee is appointed it should have the right to act independently of the insolvency representative, in order to ensure fair and unbiased representation of creditors' interests.

440. A further approach is to provide for the appointment (whether by creditors or by the court at the request of creditors) of a single person (in some laws referred to as an intervenor or inspector) to represent certain creditors or groups of creditors (for example, those holding at least ten percent of the debt). In one law where this approach has been adopted the rationale was to facilitate more orderly and timely participation by creditors and avoid the delays and disputes that previously had been encountered. The representative fulfils a role analogous to that of the creditor committee, acting on behalf of the creditors, for example, to monitor the administration of the estate by the insolvency representative or the debtor, request hearings, bring actions against the debtor, request provision of information on issues affecting the creditor's interests, or call for meetings of creditors. Under some laws, creditors are required to cover the fees of that representative in order to avoid excessive charges to the estate, while others make provision for those fees to be paid by the estate.

441. The choice between these different approaches may involve balancing factors such as time, cost, efficiency, transparency and democracy. The approach of appointing a representative, for example, may be more efficient and cost effective

and lead to more orderly proceedings with fewer disputes than the creditor committee approach. The latter approach, however, may be more transparent and a more democratic means of representing creditor interests. A further relevant factor may be the availability of well-trained insolvency professionals and effective institutional infrastructure to assist the insolvency process and a greater role may be accorded to creditors where these professionals are scarce or institutional capacity is weak.

**(d) Encouraging creditor participation**

442. An important issue that may need to be considered where an insolvency law allows creditors to participate actively in the process is how to overcome creditor apathy and encourage participation in the proceedings. It is not uncommon for creditors to adopt the view, even where the insolvency law provides for active participation, that nothing will be gained from such participation, especially where the return to creditors is unlikely to be significant and where participation may in fact require further expenditure of time and money. This common concern can be addressed to some extent by the overall balance that an insolvency law strikes between the different interests of the parties involved in the proceedings (see for example, chapter III.A.2) and by specific measures relating, for example, to selection of the creditor committee and the functions to be performed by that committee (or by creditors generally where there is no committee) (see below), as well as use of electronic means to facilitate communication and voting where required. A further concern may relate to possible liability for participating in the proceedings, particularly as a member of a creditor committee. This concern can be addressed by providing immunity from liability except in clearly defined circumstances, such as fraudulent or wilful behaviour (see below).

**(e) Need for information and notice**

443. It will be essential, in order to enable creditors to perform specific functions, that they be provided, either directly or through a creditor committee, with relevant, current and accurate information on the debtor's business and financial affairs, and be provided with notice of issues that affect their interests and on which they may be required to decide or advise. Issues of confidentiality, as noted above with respect to the debtor and the insolvency representative, will also be relevant to creditors or the creditor committee where they are provided with such information.

**(f) Secured creditors**

444. It is desirable that an insolvency law determines the extent to which secured creditors can or should participate at meetings of creditors or in a creditor committee. As a general rule, secured creditors are not represented on a creditor committee if they are fully secured or over-secured. In these cases, their interests are significantly different from those of unsecured creditors and their ability to participate in and potentially alter the outcome of decisions by creditors may not be in the best interests of all creditors. Recognizing this divergence of interests, some insolvency laws require secured creditors to surrender their security before they can participate in the proceedings and vote as a member of the creditor body. Where they are under-secured, however, their interests are more likely to align with those of unsecured creditors and their participation in the committee or in voting by the

creditor body may be appropriate, at least to the extent that they are under-secured. In proceedings such as reorganization, secured creditors will have an interest in negotiating with the debtor and other parties, particularly where their rights may be modified by a reorganization plan, or where the encumbered asset will be key to the successful implementation of the plan.

### **3. Functions to be performed by creditors**

445. As noted above, the functions to be performed by creditors vary widely between insolvency laws. In general, a determination as to which functions should be given to creditors involves a consideration of the overall design of the insolvency law and the balance to be achieved between the roles of the court, the insolvency representative, the debtor and creditors, particularly in terms of oversight and supervision.

446. In some cases, creditors perform a general advisory function and the insolvency representative may refer matters to the creditors, but will not be bound by any decision they take. Under other laws, the creditors may have specific functions to perform with regard to the conduct of the proceedings, which may involve cooperation and coordination with the insolvency representative. The insolvency representative may be required to consult with creditors on those matters before taking its decision or the decision-making power may reside with creditors. Other functions require the creditors to oversee the acts and decisions of the insolvency representative. Some of the issues in respect of which creditors may have an interest may include some or all of the following: continuation of the business in liquidation; post commencement financing; verification of claims; compensation of professionals, including the insolvency representative; exercise of avoidance powers; treatment of judicial proceedings to which the debtor was a party at the time of commencement; consideration and approval of a reorganization plan; appointing a committee or representatives of creditors; supervising the acts of the insolvency representative; distribution of assets; and consideration (and approval) of the insolvency representative's final report and accounting.

447. Where the insolvency representative is not bound to follow the decision of creditors, insolvency laws often provide that for certain acts the insolvency representative must seek the prior approval of the court, or that creditors may apply to the court to give binding instructions to the insolvency representative (or to seek replacement of the insolvency representative where the insolvency representative fails to meet its obligations or otherwise acts to the detriment of creditors). In the event of a dispute between the creditors and the insolvency representative, many laws give precedence to the decision taken at a meeting of creditors. A similar intention is found in the requirements for creditors to be consulted on any decisions that require court approval.

448. Where the insolvency law does provide creditors with the power to object to acts or decisions of the insolvency representative and where the insolvency representative does not agree with or accept such an objection, the course of action available to creditors and the applicable procedural and evidential requirements generally depend largely on the role assigned to creditors in a particular insolvency regime.

449. Where the regime provides for the actions or decisions of the insolvency representative to be supervised or approved by the general body of creditors or the creditor committee, a high level of creditor protection may ensue. Where that supervision or approval adds steps to the administration of the insolvency estate, however, it has the potential to affect the cost and efficiency of the administrative process. For these reasons an insolvency regime will need to balance the extent to which supervision or approval by creditors is required (including defining both the acts and decision that require approval and the procedure for obtaining that approval) against the independence of the insolvency representative and the desirability of speed and cost effectiveness in the conduct of the insolvency proceedings. Regimes vary in the balance reached between these possibly competing factors. Further relevant factors that may need to be taken into account include the extent to which the court plays a role in supervising the proceedings and the insolvency representative, and the manner in which the insolvency regime balances that role against the participation of creditors.

450. Whatever functions are to be performed by the creditors, it is desirable that an insolvency law clearly states whether creditors are required to undertake each of the specified functions, or whether certain functions are discretionary, and the manner in which creditors are to interact with the insolvency representative in the performance of those functions.

#### **4. Creditor meetings**

451. Many insolvency laws provide for the functions of creditors to be undertaken via general meetings of creditors. As noted above (see chapter I.B), an insolvency law should require creditors to be notified (whether by personal notice, advertisement or some other means) of the commencement of insolvency proceedings and for that notification to include advice on a number of matters, which may include details of an initial meeting of creditors, to be convened by the court or the insolvency representative within a prescribed period of time after commencement (examples of time limits included in insolvency laws range from five days to one month from the date of commencement). Under a number of insolvency laws, that initial meeting is the only meeting of all creditors that will take place. However, not all insolvency laws require such a meeting to be convened.

452. Where the insolvency laws provide for subsequent meetings of creditors to be held, different approaches are taken. Under some laws further meetings are to be convened by the court or the insolvency representative for specific purposes, while other laws include provision for creditors or the insolvency representative, and in some limited cases the debtor, to convene meetings on an ad hoc basis, as required. Where the insolvency law allows creditors to convene a meeting, the law may include certain limitations on when a meeting can be called or the conditions that must be fulfilled before a meeting can be called. These conditions may include the passing of a defined period of time after a certain step in the proceedings was to be taken, or upon the completion of defined acts or decisions of the insolvency representative or where the insolvency representative fails to act. Some laws also provide that only creditors holding a specified percentage of the total claims are entitled to call a meeting (examples include ten percent of creditors by value, creditors with no less than 25 percent of total claims or at least 25 percent of unsecured claims). A further approach allows any interested party the right to apply to the court to summon a meeting of creditors.

453. It is desirable that all creditors have the right to be heard on matters to be discussed at a creditor meeting. Where a vote of creditors is required, it is desirable that an insolvency law establishes the eligibility to vote and the voting mechanism, including in particular whether creditors are required to attend in person to vote or whether proxies and other means, such as email or the internet, can be used. Where certain kinds of creditors are included amongst a debtor's creditors, such as public bondholders, special rules may be required to facilitate their participation in the proceedings, especially where there are large number of them. It may be appropriate, for example, to permit duly authorized representatives to count towards requirements for the participation of specified numbers or percentages of creditors at a general meeting of creditors. The same considerations would also apply to requirement for voting; requirements for participation and voting in person could significantly complicate insolvency proceedings where the debtor's liabilities include publicly traded bonds.

454. It may also be desirable for an insolvency law to permit creditors to establish rules governing the conduct of creditor meetings to facilitate creditor participation, and where it would be appropriate to the role to be played by creditors in the proceedings. Issues to be covered by such rules may include eligibility to attend and participate, quorum, chairing and general conduct of the meeting.

## **5. Creditor committee**

455. Under some insolvency laws, the formation of a creditor committee or the election or appointment of a creditor representative is designed to facilitate active creditor participation in insolvency proceedings, whether liquidation or reorganization. A creditor committee or other form of creditor representation may not be required in all insolvency cases, but may be appropriate where, for example, there is a very large number of creditors, where creditors have very diverse interests, or where other features of the case indicate that such an approach is desirable or necessary (e.g. to limit time and monetary costs). Some insolvency laws provide for creditors to determine whether or not they will appoint a committee or representative, while other laws provide for the court to appoint a committee or representative to help supervise the acts of the insolvency representative. However appointed, the creditor committee should be able to act independently of the insolvency representative to ensure fair and unbiased representation of creditors' interests.

456. Where a creditor committee is formed, it will be necessary to consider the extent to which the insolvency estate will pay the costs of the committee; some insolvency laws allow creditors to form unofficial committees which are not formally recognized by the court or the insolvency representative and whose costs are not reimbursed by the insolvency estate but must be by the creditors; other laws provide that the costs of the creditor committee are to be paid by the estate. The question of who should pay is closely linked to the role of the committee, the extent to which the functions specified under the insolvency law to be performed by the creditors can be performed by a committee and the factors determining whether a committee is to be formed in any particular proceeding. Where the costs are to be borne by the estate, it is desirable that the court have the authority to limit excessive costs.



**(a) Creditors that may be appointed to a committee**

457. An insolvency law that provides for the formation of a creditor committee will need to consider which creditors will be entitled to be appointed to that committee. Different approaches are taken to that issue. Some insolvency laws provide, for example, that only creditors whose claims have been admitted (by the court or the insolvency representative, depending upon the admission procedure) can be appointed, while other laws provide for appointment of a provisional committee, for which all creditors are eligible, until all claims have been verified and admitted. Other insolvency laws impose restrictions on the location of creditors who may serve on a creditors committee. To ensure equality of treatment of creditors, however, it is desirable that creditors such as those whose claims have only been provisionally admitted and foreign creditors are eligible for appointment to the committee.

458. A second issue relates to the types of creditors to be represented. Although creditor committees generally represent only unsecured creditors, some laws recognize that there may be cases where a separate committee of secured creditors is justified. Those systems base this approach on the fact that the interests of the different types of creditors do not always converge and the ability of secured creditors to participate in, and potentially affect, the outcome of decisions by the committee may not always be appropriate or in the best interests of other creditors. Nevertheless, it is also recognized that in certain circumstances, as noted above (see (b)(vi)), the participation of secured creditors will be appropriate.

459. Other insolvency laws provide for both types of creditors to be represented on the same committee. The rationale of this approach is that since the creditor committee is responsible for participating in the decision-making process and for making important decisions, secured creditors should participate otherwise they are excluded from the making of important decisions which may affect their interests (particularly where they are not fully secured). A further approach may be for an insolvency law not to specify which creditors should be represented in a given case, but to allow creditors to collectively choose their own representatives on the basis of willingness to serve (to address the common problem of creditor apathy) and to provide for enlargement or reduction of the size of the committee as required. Where the types of creditors requiring representation are too diverse to accommodate their interests within a single committee, as may be the case for special interest groups such as tort claimants and shareholders, an insolvency law could provide for different committees to represent different interests. It is desirable, however, that this mechanism only be used in special cases, in order to avoid unnecessary costs and the possibility of the creditor representation mechanism becoming unwieldy.

460. The participation of equity holders and creditors related to the debtor may be controversial, especially where the creditor committee has the power to affect the rights of secured creditors or where the equity holders are involved with the management of the debtor. There will be cases, however, where those parties have no direct knowledge of, or involvement with, the management of the debtor, such as where they are investors with no direct association with or access to management. In such cases, there may be compelling reasons for allowing them to participate through their own committee. Other creditors who may have a conflict of interest (such as competitors of the debtor who may have a personal interest with the potential to affect their impartiality in carrying out the functions of the committee)

may also need to be excluded from participation in a committee in order to ensure that the committee is able to perform its functions on behalf of the creditor body impartially and independently.

461. A similar question of participation may arise in respect of parties who purchase the claims of creditors. Such purchasers may be related to the debtor or may be third parties who have no particular interest in the business of the debtor. Third party purchases may give rise to concerns about access to sensitive, confidential information that may be of value in the secondary debt market, while related party purchases raise the question of whether the related party should be entitled to claim the original face value of the claim or only the amount actually paid for it (where there is a difference between the two), which may affect the ability to vote where it is directly related to the value of claims.

462. To address any potential problem, an insolvency law could adopt the approach of stipulating which parties are not entitled to participate in a creditor committee or vote on particular matters, such as selection of an insolvency representative or approval of a reorganization plan.

**(b) Formation of a creditor committee**

463. Where the law provides for the formation of a creditor committee, details of the manner in which the committee is to be formed, the scope and extent of its duties, its governance and operation, including voting eligibility and powers, quorum and conduct of meetings, as well as replacement and substitution of members are often also addressed. It may be desirable to include such provisions on some of these issues, particularly with respect to voting eligibility, duties and replacement and substitution of members, in an insolvency law not only to avoid disputes and ensure confidentiality, but also to provide transparent and predictable procedures. Other issues, can be addressed in procedural rules adopted by the committee, including rules on voting procedures and majorities; meeting procedure; election of a chairperson; and resolution of disputes.

464. A number of different approaches are taken to appointing the members of the committee, which depend to a large extent on the functions to be performed by the particular committee. In many cases, creditors are responsible for appointing the committee, normally at the initial meeting of creditors, or upon the provision by the insolvency representative of preliminary information regarding the debtor. Appointment of the committee by creditors may encourage both creditor confidence and participation in the insolvency process. Some jurisdictions allow the court to appoint a creditor committee, either at its own instigation or upon application by creditors or the insolvency representative. This approach may have a number of disadvantages, including that it has the potential for perceptions of bias, and a lack of equity and transparency; creditors may not have confidence in a system that does not encourage or allow them to play a role in selecting their own representatives; and it may not serve to overcome the widespread problems of creditor apathy. On the other hand, such an approach may serve to simplify the procedure for establishing a creditor committee and reduce the scope for disputes between creditors that can lead to delay and cost. The choice between these different approaches may depend upon the extent to which the court supervises the insolvency proceedings and is involved on a day-to-day basis, and the extent to

which creditors are required to undertake an active role in performing functions that require more than the provision of advice to the insolvency representative.

465. To facilitate administration of the committee, some insolvency laws specify the size of the committee—generally an odd number in order to ensure the achievement of a majority vote, and in some cases no more than three or five persons. Where the committee represents only unsecured creditors, membership of the committee is sometimes limited to the largest unsecured creditors. These creditors can be identified by a number of means, including requiring the debtor to prepare a listing of its largest creditors or by reference to the list of creditors to be prepared by the debtor. To ensure that it fulfils its duty to fairly represent creditors, oversight of the committee may be desirable where the insolvency law provides for the committee to undertake a significant role and could be undertaken by the insolvency representative, or by the court.

**(c) Functions of a creditor committee**

466. As a general proposition, a creditor committee will perform its functions on behalf of the creditors and those functions will therefore be related directly to the general functions given to creditors as noted above. The powers and functions given to a creditor committee, however, should not impair the rights of creditors as a whole to continue to participate or otherwise act in the insolvency proceeding. With respect to decision-making, the creditor committee generally will play an advisory role, making recommendations to creditors on how key issues should be decided, but it would not usually have the authority to make major decisions on behalf of creditors. While the creditor committee will interact with the insolvency representative, where one is appointed, or with the debtor-in-possession where the insolvency law adopts that approach to reorganization, the committee should be able to act independently of those parties in representing the interests of creditors.

467. Insolvency laws provide for a creditor committee to undertake a range of functions which may include advising the insolvency representative the wishes of creditors on issues such as the sale of significant assets and formulation of the reorganization plan, consulting with the insolvency representative and other principals in the proceeding, such as the existing management of the debtor, participating in the development of a reorganization plan or possibly supervising the insolvency representative. These functions may be established by the insolvency law, directed by the court or determined in cooperation with the insolvency representative.

468. As noted above with respect to creditors generally, the committee will need to be able to access up-to-date information on the debtor and its financial affairs from the insolvency representative and be able to express its views and those of creditors on matters falling within those functions or on matters in which affect the interests of creditors. To perform its functions, the committee may also require administrative and expert assistance, although the need for such assistance should be clearly linked to the functions to be performed by the committee. The committee may be required under the law to seek permission from the insolvency representative or the court to hire a secretary and, if circumstances warrant, consultants and professionals. Some insolvency laws provide that the costs of hiring assistants, including their remuneration, will be paid by the insolvency estate, while other laws provide that creditors must meet their own costs of participation in the insolvency proceedings. Where the costs are to be paid by the estate, it is desirable that the court has some

control not only over the decision to hire such professional, but also over the associated costs and charges.

**(d) Liability of the creditor committee**

469. The committee's duty would be owed to creditors generally. It would not have any liability or fiduciary duty to the owners of the insolvent business. It may be desirable for the insolvency law to require the committee to act in good faith and to provide that members of the committee would be immune from liability in respect of actions and decisions taken by them as members of the committee unless they were found to have acted fraudulently or wilfully or to have breached a fiduciary duty to the creditors they represent. This might include, for example, deriving profit from the administration of the estate; or acquiring assets forming part of the estate without prior approval of the court. The standard of liability for the committee can be distinguished from that of the insolvency representative, as committee members are not required to satisfy any requirements as to knowledge of expertise and are acting in a voluntary capacity without remuneration. In considering the question of the liability of the committee, a balance may need to be struck between setting too high a level of responsibility that will promote creditor apathy and effectively discourage creditors from participating, and too low a level that may lead to abuse and prevent the committee from functioning efficiently as a representative body.

**(e) Removal and replacement of members of the committee**

470. An insolvency law may need to give some consideration to the grounds upon which removal of a member of the creditor committee might be justified and to establishing a mechanism for replacement. Those grounds might include gross negligence, lack of the necessary skills, incompetence, inefficiency, lack of independence or conflict of interest. The procedure for such removal and replacement generally will depend upon the procedure for appointment of a creditor committee, whether by the court or election by creditors. A mechanism for replacement of members of the committee will also be relevant where members of the committee resign or are unable to continue performing the required functions, such as in cases of serious illness or death.

**6. Matters requiring a vote by creditors**

471. An insolvency law will need to identify the matters on which a vote of the creditors is required as well as to establish the applicable voting requirements in each case.

472. Where actions to be taken in the course of the proceedings will have a significant impact on the creditor body, it is desirable that all creditors (as opposed to just the creditor committee) are entitled to receive notice of, and to vote on, those actions. These actions may include voting to select the insolvency representative where an insolvency law provides creditors with this role; approval of the reorganization plan; approval of post-commencement finance; and on other significant events such as sale of substantial assets.

473. A number of different approaches can be taken with respect to achieving that vote, depending upon the nature of the matter to be decided. Some laws provide that voting should occur in person at a meeting of creditors, while other laws provide that where a large number of creditors are involved or where creditors are not local

residents, voting may take place by mail or by proxy. The practicality of requirements for voting in person will clearly be challenged where there are large numbers of creditors, and especially of certain kinds of creditors such as public bondholders. It will be increasingly desirable to permit voting to take place using electronic means, including email and the internet, which can be subject to appropriate security measures.

474. Different approaches are taken to the type of voting result that is required to bind creditors to different decisions, with some insolvency laws distinguishing between different types of decisions to be made. More important decisions, such as approval of a reorganization plan, may require a vote that includes both a proportion of value of claims as well as a number of creditors (see part two, chapter IV). Some laws require a majority in value for most decisions and for decisions such as election or removal of the insolvency representative and hiring of particular professionals by the insolvency representative, a majority in value and number is required. Other laws provide that a simple majority is sufficient on issues such as election or removal of the insolvency representative. Some laws also distinguish between matters requiring the support of both secured and unsecured creditors; secured creditors will only participate in the vote on specified matters such as selection of the insolvency representative and matters affecting their security.

## **7. Confidentiality**

475. As noted above (chapter III.A and B), it is desirable that an insolvency law imposes obligations of confidentiality on both the debtor and the insolvency representative. For similar reasons, it may be appropriate to also consider the circumstances in which creditors should be required to observe confidentiality. In the course of the administration of an insolvency proceeding, creditors generally will be in a position to obtain significant amounts of information concerning the debtor and its business, much of which may be commercially sensitive. While the consequences of liquidation suggest that there may not be much opportunity for creditors to take unfair advantage of that information (or that harm to the debtor will result), that may not be true of reorganization, and there may be circumstances where creditors can use that information to affect the successful implementation of an agreed plan. For these reasons, it may be appropriate to impose on creditors and the creditor committee (and any professionals employed by it) an obligation of confidentiality that permits the use of information obtained in the course of the proceedings only for the purposes of administration of the proceedings, unless the court decides otherwise. In cases where a creditor committee is appointed (and the committee hires professional advisors), the obligation may be given effect by requiring members of the committee (and the professional advisors) to sign confidentiality agreements.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on participation of creditors in insolvency proceedings is to:

- (a) facilitate participation of creditors in insolvency proceedings;

(b) provide a mechanism for the appointment of a creditor committee or other creditor representative where to do so would facilitate the participation of creditors in the insolvency proceedings;

(c) ensure the right of creditors to access information on the insolvency proceedings;

(d) specify the functions and responsibilities of the creditor committee.

### **Contents of legislative provisions**

*Right to be heard (see recommendation (121))*

*Participation by creditors*

(110) The law should specify that creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and identify what that participation may involve in terms of the functions that may be performed.

*Voting by creditors*

(111) The law should specify the matters on which a vote of creditors is required and establish the relevant eligibility and voting requirements. In particular, the law should require the vote of creditors to approve or reject a reorganization plan.

*Convening meetings of creditors*

(112) The law may require a first meeting of creditors to be convened within a specified time period after commencement to discuss certain matters. The law may also permit the court, the insolvency representative or creditors holding (*specify a percentage of the total value of*) unsecured] claims to request the convening of a meeting of creditors generally. The law should specify the party responsible for giving notice to creditors of such a meeting. The law may specify the circumstances in which such a meeting of creditors may be convened.

*Creditor representation*

(113) The law should facilitate the active participation of creditors in insolvency proceedings such as through a creditor committee or other mechanism for representation.<sup>86</sup> The law should specify whether a committee or other representation is required in all insolvency proceedings. Where the interests and categories of creditors involved in insolvency proceedings are diverse and participation will not be facilitated by the appointment of a single committee or representative, the law may provide for the appointment of different creditor committees or representatives.

(114) Where the law permits a creditor committee or representative to be appointed the relationship between the creditors and the creditor committee or representative

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<sup>86</sup> See recommendation (97) and the continuing role of the debtor in reorganization. Where the debtor remains in possession of the business, a creditor committee will have an important role to play in overseeing and, where necessary, reporting on the activities of the debtor.

should be clearly specified.<sup>87</sup> The law should specify how the costs of the creditor committee would be paid.

*- Creditors that may be appointed to a creditor committee*

(115) The law should specify the creditors that are eligible to be appointed to a committee. The creditors who may not be appointed to the creditor committee would include related persons and others who for any reason might not be impartial. The law should specify whether or not a creditor's claim must be admitted [whether provisionally or otherwise] before the creditor is entitled to be appointed to a committee.

*- Mechanism for appointment to a creditor committee*

(116) The law should establish a mechanism for appointment of a creditor committee. Different approaches may include selection of the creditor committee by creditors or appointment by the court or other administrative body.

*- Rights and functions of a creditor committee*

(117) The law should specify the rights and functions of the creditor committee in insolvency proceedings, which may include:

(a) providing advice and assistance to the insolvency representative or the debtor-in-possession;

(b) participating in development of the reorganization plan, the sale of significant assets and in other matters in which their class has an interest as directed by the court or determined in cooperation with the insolvency representative;

(c) the right to hear the insolvency representative at any time.

*- Employment and remuneration of professionals by a creditor committee*

(118) The law should permit a creditor committee, subject to approval by the court to select, employ and remunerate professionals that may be needed to assist the creditor committee to perform its functions. The law should specify how the costs and remuneration of those professionals would be paid.

*- Liability of members of a creditor committee*

(119) The law should specify that members of a creditor committee are exempt from liability for their actions in their capacity as members of the committee unless they are found to have acted fraudulently or to be guilty of wilful misconduct.

*- Removal and replacement of members of a creditor committee*

(120) The law should specify the grounds for removal of members of a creditor committee and provide for their replacement.<sup>88</sup>

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<sup>87</sup> In particular, the law should specify: the distribution of functions and powers between the creditors and the creditor committee, and the mechanism for resolution of disputes between the creditors and the creditor committee.

<sup>88</sup> Exercise of the power to remove will depend on the method of appointment of the committee.

## **D. Party in interest's right to be heard and to appeal**

### **1. Right to be heard**

476. Most regimes provide creditors, as the primary beneficiaries of the estate, and other parties in interest with some ability to scrutinize both the administration of the estate and the conduct of the insolvency representative in performing its duties. The insolvency representative, the debtor, a creditor, a creditor committee or another party in interest may wish to request relief under the insolvency law or may oppose requests of others for such relief. Each of those parties should have a right to be heard when their rights, interests in property or duties under the insolvency law are affected. Where decisions relating to administration of the estate are to be made by the courts, those decisions generally may be appealed to a higher court by a party whose interests are affected, although some insolvency laws do exempt certain decisions from appeal (e.g. the decision appointing the supervising judge or commencing the proceedings).

### **2. Review procedures**

477. Procedural approaches to the administration of an estate are largely determined by the rules governing the duties of the insolvency representative, the rights and duties of the debtor under the insolvency law and the active role, if any, of creditors, either separately or through a creditor committee, in the administration. For example, in those laws which require the insolvency representative to gain the approval of creditors, or their representatives, before undertaking certain acts, direct involvement of creditors in the decision-making process will normally preclude the need for a review procedure by creditors with respect to those acts, apart from those situations where the insolvency representative has misled creditors.

478. Where acts of the insolvency representative are not subject to the prior approval of creditors, there may be a need for a formal review procedure by creditors. A formal review procedure may be appropriate for other parties in interest when acts of the insolvency representative affect them.

479. Most insolvency laws require a party in interest to raise its requests for relief or objections through a court action. Some insolvency laws allow individual creditors to bring an action, while others require the objecting creditor or creditors to represent a certain number of creditors or percentage of the debt to have legal standing to proceed with the action, or even require the action to be brought by the creditors committee or the creditors generally. Such requirements may depend upon the grounds of the objection raised. Other parties in interest may have legal standing to raise an objection or request relief when their rights, interests in property or duties under the insolvency law are affected. As discussed above, the right to be heard must be balanced with the need for efficient administration of the insolvency proceedings.

### **3. Right of appeal**

480. A party in interest who has requested relief and been denied, or who has unsuccessfully opposed a request or act of another party should have a right to appeal to a higher court if it believes that the court was in error. Most judicial systems establish a hierarchy of courts for appellate review and procedures to invoke that review. A similar structure should apply to the court that administers the insolvency law and to orders entered by that court.



## Recommendations

### *Right to be heard*

(121) The law should specify that a party in interest has a right to be heard on any issue in the insolvency proceedings that affects its rights, obligations or interests. For example, a party in interest should be entitled to:

- (a) object to any act that requires court approval;
- (b) request review by the court of any act for which court approval was not required or not requested;
- (c) request any relief available to it in insolvency proceedings.

### *Right of Appeal*<sup>89</sup>

(122) The law should specify that a party in interest may appeal from any order of the court in the insolvency proceedings that affects its rights, obligations or interests.

## IV. Reorganization

### A. The reorganization plan

#### 1. Introduction

481. Insolvency laws generally address a number of issues in relation to the reorganization plan, such as the nature or form of the plan; when the plan is to be prepared; who is able to prepare the plan; what is to be included in the plan; how the plan is to be approved by creditors (and confirmed by the court where that is a requirement); the effect of the plan and how it is to be implemented.

482. Reorganization plans perform different functions in different types of proceedings. In some, the plan may be the tailpiece of the reorganization proceedings, dealing with the pay-out of a dividend in full and final settlement of all claims (also referred to as a composition or a scheme of arrangement) and the final structure of the business after the reorganization is complete. In others, the plan may be proposed at the commencement of the proceedings and set out the way the debtor and the business should be dealt with during the reorganization period, much like a business plan, as well as expected dividends and dates of payment. There may also be circumstances where a plan, like a plan of reorganization, is prepared in liquidation where the business is to be sold as a going concern. Such a plan may address issues such as the timing and mechanics for interim distributions. The following discussion focuses upon the issues that would be relevant to a plan proposed at some time after the proceedings have commenced, addressing the conduct of the business in reorganization and the transformation of legal rights

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<sup>89</sup> In accordance with the key objectives, the insolvency law should provide that appeals in insolvency proceedings should not have suspensive effect unless otherwise determined by the court, in order to ensure that insolvency can be addressed and resolved in an orderly, quick and efficient manner without undue disruption. Time limits for appeal should be in accordance with generally applicable law, but in insolvency need to be shorter than otherwise to avoid interrupting insolvency proceedings.

proposed to address the debtor's financial situation. These considerations will also be relevant, although not necessarily in their entirety, to other types of plans.

## **2. Nature or form of a plan**

483. The purpose of reorganization is to maximize the possible eventual return to creditors, providing a better result than if the debtor were to be liquidated and to preserve viable businesses as a means of preserving jobs for employees and trade for suppliers. With different constituents involved in the reorganization process, each may have different views of how the various objectives can best be achieved. Some creditors, such as major customers or suppliers, may prefer continued business with the debtor to rapid repayment of their debt. Some creditors may prefer an equity stake in the business, while others will not. Typically, therefore, there is a range of options from which to select in a given case and if an insolvency law adopts a prescriptive approach to the range of options available or to the choice to be made in a particular case, it is likely to be too constrictive. It is desirable that the law does not, for example, permit a plan that is designed only to fully rehabilitate the debtor; nor provide that debt cannot be written off; nor provide that a minimum amount must eventually be paid to creditors; nor prohibit exchange of debt for equity. A non-intrusive approach that does not adopt such limitations is likely to provide the flexibility sufficient to allow the most suitable of a range of possibilities to be chosen for a particular debtor.

484. Some insolvency laws adopt an illustrative approach, listing some of the possibilities that may be adopted, but it is not intended that the list be exhaustive or exclusive of other approaches. These possibilities could include a choice of a simple composition (an agreement to pay creditors a percentage of their claims, usually over time); the continued trading of the business and its eventual sale as a going concern (and for the debtor to then be liquidated); transfer of all or part of the assets of the estate to one or more existing businesses or to businesses that will be established; a merger or consolidation of the debtor with one or more other business entities; a sophisticated form of restructuring of debt and equity; or some other solution. The determination of what is the most appropriate solution may best be left to the market place, where an effective one exists, or at least to negotiations among the debtor, the insolvency representative, creditors and other persons with economic interests.

485. Even if it does not adopt a prescriptive approach to the form or nature of the plan, an insolvency law may establish some limits, such as that the priorities afforded to creditors in liquidation should be maintained in reorganization, that the effect of the plan should not be such that the debtor remains insolvent and is returned to the market place in that condition, and that the reorganization plan comply with limitations set forth in other laws (where the insolvency law does not amend those limitations), for example foreign exchange controls.

## **3. Proposal of a reorganization plan**

486. Two important issues to be considered in relation to the proposal of a reorganization plan are the stage of the proceedings at which it should be proposed and the party or parties that would be capable of proposing, or could be authorized to propose, a plan. A number of different approaches can be taken to each of these issues.

**(a) Timing of proposal**

487. As to the first issue, timing of proposal, the approach adopted may depend upon the purpose or objective of the particular reorganization, or relate to the manner in which the reorganization proceedings commenced. Some laws, for example, provide that the plan for reorganization should be filed with the application for reorganization proceedings (where the application may be called a “proposal” for reorganization) where those proceedings are proceedings commenced by the debtor.<sup>90</sup> Potential difficulties with this approach may include delaying the debtor’s ability to commence proceedings and obtain timely relief by way of the stay; the difficulty of knowing, at this early stage, exactly what the plan should accomplish; and if the plan has been prepared without consultation with creditors and other interested parties but is intended to be a final, definitive plan, it may not be a plan that could feasibly be implemented and could thus operate to pre-empt the proceedings and also cause delay. Many other laws provide for the plan to be negotiated and proposed after commencement of reorganization proceedings. This may be a more flexible option, allowing consultation and negotiation of an acceptable reorganization plan while the debtor has the protection of the stay. These benefits may need to be balanced against possible misuse of the insolvency regime by debtors who have no intention of, or ability to, propose a plan but are seeking to obtain only the benefits of the stay. Issues of timing of proposal of the plan may also arise where proceedings are converted from liquidation to reorganization (see 14 below).

**(b) Parties permitted to propose a plan**

488. With regard to the second issue, participants in the reorganization proceedings may have different capabilities and responsibilities with regard to negotiation and proposal of a reorganization plan, depending upon the manner in which the insolvency law is designed and in particular the respective roles assigned to the insolvency representative, debtor and creditors. For example, in some insolvency laws, these parties have a positive obligation to cooperate in negotiating and proposing a plan. In determining which party should be permitted to propose, or which parties are capable of proposing, a plan, a balance may be desirable between the freedom accorded to the different parties to propose a plan (e.g. should all parties be able to propose a plan, should they be able to do so at the same time or should proposal by different parties be sequential and dependant upon the acceptability of a plan proposed), and the restraints necessarily attached to the process in terms of approval (voting) requirements (e.g. should all creditors play a role in formulating a plan they have to approve), time limits for negotiation and proposal, provision in the insolvency law for amendment of the plan and other procedural considerations. A flexible approach, as opposed to a prescriptive approach, is likely to ensure that this balance is achieved, although in the interests of efficiency, certainty and predictability and the timely progress of the proceedings, it is desirable that an insolvency law provide sufficient guidance to ensure that a viable plan is proposed.

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<sup>90</sup> This type of approach is not to be confused with an application for an expedited proceeding which would be accompanied by the plan approved by creditors, see chapter IV.B.

(i) *Proposal by the debtor*

489. Where the plan is to be proposed before commencement, it would generally be proposed by the debtor, but may involve negotiation with one or more classes of creditors, not necessarily all, who may negotiate and agree on a plan, subject to its acceptance by other creditors or its imposition on remaining classes. Where the plan is to be proposed after the commencement of proceedings, some insolvency laws provide that the debtor should propose a plan, sometimes specifying that it should do so in cooperation with other parties such as the insolvency representative, the creditors, an attorney, an accountant or other financial advisors. An approach which involves the debtor may have the advantage of encouraging debtors to commence reorganization proceedings at an early stage and, where the plan envisages the ongoing operation of the debtor's business, of making the best use of the debtor's familiarity with its business and knowledge of the steps necessary to make the insolvent business viable (although the freedom accorded to the debtor may need to be balanced against the need to ensure creditor confidence in the debtor and its proposal). The benefits of such an approach also may be clear where key management personnel of the debtor are necessary to the success of the business (such as for reasons of its complexity) or will be difficult to replace in the short term.

490. Some insolvency laws provide that the opportunity given to the debtor is exclusive. Other laws adopt a staged approach, with the opportunity for proposal by the debtor being exclusive only for a specified period. The court may have the power to extend the period if the debtor can show the delay is justified and there is a real prospect of a successful reorganization, and another party is able to propose a plan where the debtor's exclusive period expires without a plan being proposed.

(ii) *Proposal by creditors*

491. Where creditor approval of the plan is required, there is always a risk that reorganization will fail if the plan presented by the debtor is not acceptable. For example, creditors may only wish to approve a plan that deprives the debtor's shareholders of a controlling equity interest in the debtor's business and may also deprive the incumbent management of any management responsibilities. If the debtor has an exclusive opportunity to propose the plan and refuses to consider such an arrangement, there is a danger that the reorganization will fail, to the detriment of the creditors, the employees, and the debtor itself. To address that situation, some insolvency laws provide that, in preparing its plan, the debtor should cooperate and negotiate with creditors and if the debtor fails to propose an acceptable plan before the end of an exclusive period, the creditors are given the opportunity to propose a plan (which could be achieved through a creditor committee (see chapter III.C)). This option may provide the leverage necessary to reach a compromise between the participating parties.

(iii) *Proposal by the insolvency representative*

492. Another approach adopted by many insolvency laws is to give the insolvency representative an opportunity to propose a plan, either as an alternative to proposal by the debtor or the creditors or as a supplementary measure. Given that the insolvency representative will have had some opportunity to become knowledgeable about the debtor's business after commencement of the proceedings, it may be well

placed to determine what measures are necessary for the business to be viable. It may also be well placed to facilitate negotiations on the plan between the debtor and creditors. The importance of providing for participation by the insolvency representative depends upon the design of the law and, in particular, requirements for approval of the plan by creditors or the court. Where approval by creditors is required, a plan that takes account of proposals that will be acceptable to creditors has a greater likelihood of being approved than one which does not. This consideration may not apply where creditor approval is not necessary or where the court has the power to decline to confirm an approved plan for reasons other than procedural fairness, for example, economic feasibility. Where the plan is only to be approved by the court, substantial legal input may be required to ensure that the plan presented will be approved. Where the insolvency representative is not given the opportunity to negotiate and propose a plan or to participate in that process, it may be desirable to provide an opportunity for the insolvency representative to consider the plan proposed before it is submitted for approval.

(iv) *Proposal by multiple parties*

493. Some insolvency laws provide that a number of parties have the opportunity to propose a plan. These may include the debtor the insolvency representative, and creditors or the creditors committee. It may be desirable where such a provision is included that some procedure is adopted to ensure that a number of competing plans are not proposed simultaneously. Although in some cases this competitive approach may promote the proposal of a mutually acceptable plan, it may also have the potential to complicate the process and lead to confusion, inefficiency and delay.

494. Some laws provide for the court to consider the opinions of third parties on the plan, such as governmental agencies and labour unions. Although including these parties in plan negotiation in particular cases may assist in the proposal of an acceptable plan, it also has the potential, if adopted as a general principle, to complicate and lengthen the duration of the process. It may be desirable only if it is likely to be beneficial in a particular case where the interests of those parties are central to the reorganization plan, and where the negotiation process is carefully monitored and time limits are specified.

(c) **Time limits for proposal of a plan**

495. Some insolvency laws specify a time period after commencement within which a plan is to be proposed. This limit may apply specifically to proposal of a plan by the debtor or generally. One law, for example, provides a 120-day limit for proposal of a plan by the debtor; once that has expired any other party may propose a plan without any time limit being imposed. Examples of time limits generally applicable to negotiation and proposal of a plan range from 35 to 120 days from commencement, with some laws including provision for that time limit to be extended or shortened by the court in certain circumstances. Although the imposition of time limits may be helpful in ensuring that the reorganization proceeds without delay, that advantage may need to be balanced against the risk that the deadline may be too inflexible and impose an arbitrary restraint, particularly in large cases where negotiation and proposal of a plan may take significantly longer, such as more than 12 months; that the limits will not be observed, especially in the absence of appropriate sanctions; or that the insolvency infrastructure is unable to

manage deadlines (for reasons such as lack of resources). One means of addressing the concern of inflexibility is to provide for the time period to be extended by the court, provided the extension is for a further limited period and that an unlimited number of extensions is not available. An advantage of that approach is that it requires the party seeking an extension to demonstrate to the court that the extension is warranted—that is, for example, that there is no improper reason for the delay (e.g. it is because of a need for further consultations with creditors or there has been a delay in receiving assessments or reports from professional advisors), that the delay will not be harmful to the interests of the other parties, and that, if the extension is granted, there is a real prospect for proposal of a plan that will be approved by creditors.

496. Where an insolvency law includes time periods for the negotiation and proposal of a plan, consideration will need to be given to those proceedings that are converted from liquidation. The standard time periods that would be applicable by reference to commencement of proceedings (i.e. the liquidation proceedings) may not easily be applied in those cases that rely on the original application for commencement and treat the conversion as a continuation of those proceedings.

#### **4. The plan**

497. The outcome of the plan rests on what is feasible, in other words whether, on the basis of known facts and circumstances and reasonable assumptions, the plan and the debtor are more likely than not to succeed. Determination of whether a plan is likely to succeed raises two related issues. The first is the content of the plan itself, or in other words what is proposed by the plan. The second is the manner in which those proposals are presented and explained to creditors in order to elicit their support.

##### **(a) Content of a plan**

498. The question of what is to be included in the plan is closely related to the procedure for approval of the plan (for example, which creditors are required to approve the plan, the level of support required for approval and the procedure for court confirmation, if any), and the effect of the plan once approved (and confirmed by the court, where required) (for example, will it bind dissenting creditors and secured creditors and who will be responsible for implementation of the plan and for ongoing management of the debtor) and whether or not there is a requirement for court confirmation. Many insolvency laws include provisions addressing the content of the reorganization plan. Some laws address the content of the plan by reference to general criteria, such as requirements that the reorganization plan should adequately and clearly disclose to all parties information regarding both the financial condition of the debtor and the transformation of legal rights that is being proposed in the plan, or by reference to minimal requirements such as that the plan must make provision for payment of certain preferred claims. It should be noted that a plan need not alter or otherwise effect the rights of every class of creditor.

499. Other laws set out more specific requirements as to what information is required in relation to the debtor's financial situation and the proposals included in the plan. Information on the financial situation of the debtor may include asset and liability statements; cash flow statements; and information relating to the causes or reasons for the financial situation of the debtor. Information relating to what is

proposed by the plan may include, depending upon the objective of the plan and the circumstances of a particular debtor, details of classes of claims; claims impaired under the plan and the treatment to be accorded to each class under the plan; the continuation or rejection of contracts that are not fully executed; the treatment of un-expired leases; measures and arrangements for dealing with the debtor's assets (e.g. transfer, liquidation, retention); the sale or other treatment of secured assets; the disclosure and acceptance procedure; the rights of disputed claims to take part in the voting process and provisions for disputed claims to be resolved; arrangements concerning personnel of the debtor; remuneration of management of the debtor; financing implementation of the plan; extension of the maturity date or a change in the interest rate or other term of outstanding security interests; the role to be played by the debtor in implementation of the plan and identification of those to be responsible for future management of the debtor's business; the settlement of claims and how the amount that creditors will receive will be more than they would have received in liquidation; payment of interest on claims; distribution of all or any part of the assets of the estate among those having an interest in those assets; possible changes to the instrument or organic document constituting the debtor (changes to by-laws, articles of association etc.) or the capital structure of the debtor or merger or consolidation of the debtor with one or more persons; the basis upon which the business will be able to keep trading and can be successfully reorganized; supervision of the implementation of plan; and the period of implementation of the plan, including in some cases a statutory maximum period.

500. Rather than specifying a wide range of detailed information to be included in a plan, it may be desirable for the insolvency law to identify the minimum content of a plan, focussing upon the key objectives of the plan and procedures for implementation. For example, the insolvency law may require the plan to detail the classes of creditors and the treatment each is to be accorded in the plan; the terms and conditions of the plan (such as treatment of contracts and the ongoing role of the debtor); and what is required for implementation of the plan (such as sale of assets or parts of the business, extension of maturity dates, changes to capital structure of the business and supervision of implementation).

501. The content of the plan also raises issues related to other laws. For example, to the extent that national law precludes debt-for-equity conversions, a plan that provides for such a conversion could not be approved. Since debt-for-equity conversion can be an important feature of reorganization, it would be necessary to eliminate the prohibition, at least in the insolvency context, if such provisions were to be included in a plan and approved. Similarly, if a plan is limited by the operation of other law to providing only for debt forgiveness or the extension of maturity dates, it may be difficult to obtain creditor approval. Some insolvency cases raise similarly straightforward and uncontroversial issues of the relationship between the insolvency law and other laws. Other cases may raise more complicated questions. These may include limits on foreign investment and foreign exchange controls (especially in cases where many of the creditors are non-residents), or the treatment of employees under relevant employment laws where, for example, the reorganization may raise questions of modification of collective bargaining agreements, or questions related to taxation law.

502. Approaches to these issues vary. In some countries, the insolvency law will be subject to these types of limitations, with the consequence that options for

reorganization may be restricted. Other insolvency laws allow certain limitations contained in other laws, for example those relating to disposition of the debtor's assets and priority of distribution, to be overruled in specified circumstances, such as where creditors agree. It is desirable that restrictions in other laws that will impact on the insolvency law be considered in designing the insolvency law and that, in order to ensure transparency and predictability, an insolvency law specifically address the question of its relationship with other laws, where possible noting the impact of those other laws in the insolvency law.

**(b) Information to accompany the plan**

503. When voting on a plan, creditors and other relevant interested parties, such as equity holders, who may be required to vote on the plan, need to be able to assure themselves that what is proposed by the plan is feasible and not based, for example, on faulty assumptions, and that implementation of the plan will not leave the debtor overburdened with debt. To facilitate that evaluation, creditors and other relevant interested parties will need to be provided with information explaining what the plan proposes and the impact of those proposals on the debtor, creditors and other affected parties. For these purposes, the plan can be submitted to creditors and others together with a disclosure statement providing a full disclosure of information that will enable all parties to properly evaluate the plan. That statement may be prepared by a qualified professional who can be expected to provide a credible and unbiased assessment of the measures proposed by the plan or by the same party as proposes the plan, with or without professional advice. Where the insolvency representative is not involved in the proposal of a plan or preparation of the statement, it may be desirable to require it to comment on both instruments. Where creditors and other relevant interested parties do not agree with the professional evaluation, or do not believe that the disclosed information is persuasive, those views could be taken into account either in voting on the plan, by a mechanism allowing for amendment of the plan, or by the court when it confirms the plan (where that is a required element of the process).

504. A number of insolvency laws include provisions specifying the information that is to be provided to creditors and other interested parties to enable them to properly assess the plan, whether it is to be included in the plan itself or in a separate statement. A requirement to provide this information, supported by appropriate mechanisms for obtaining relevant information satisfies the key objective of transparency and can assist in ensuring creditor confidence in the insolvency process. It may need to be balanced, however, against confidentiality concerns arising from access to potentially sensitive financial and commercial information relating to the debtor, even where that information may ultimately enter the public domain through approval or confirmation of the plan by a court. This concern can be addressed in the law by including obligations to observe confidentiality that will apply to the debtor, creditors, the insolvency representative and other interested parties. The requirement may also need to be balanced against the provision of information that is irrelevant to the purpose of evaluating the plan; the focus should be upon the information required in a particular case to evaluate the specific proposals contained in the plan.

505. It is desirable that an insolvency law specifies the minimum information to be provided in a disclosure statement. This could include information relating to the



financial situation of the debtor, including asset and liability and cash flow statements; a comparison of the treatment afforded to creditors by the proposed plan and what they could be expected to receive in liquidation; the basis upon which the debtor's business would be able to keep trading and be successfully reorganized; information on voting mechanisms applicable to approval of the plan; information showing that, having regard to the effect of the plan, adequate provision has been made for satisfaction of all obligations provided for in the plan and that the debtor is expected to have the cash flow to pay its debts as provided in the plan.

## 5. Approval of a plan

506. Designing the provisions of an insolvency law on approval of the plan requires a balance to be achieved between a number of competing considerations, such as whether or not creditors should vote on approval of the plan in classes and the manner in which dissenting creditors will be treated. A underlying principle is that creditors can only be bound by a plan if they have been given the opportunity to vote on that plan. The primary purpose for classifying claims is to satisfy the requirements to provide fair and equitable treatment to creditors, treating similarly situated claims in the same manner and ensuring that all creditors in a particular class are offered the same menu of terms by the reorganization plan. It is one way to ensure that priority or preferential claims are treated in accordance with the priority established under the insolvency law. It may also make it easier to treat the claims of major creditors who can be persuaded to receive different treatment from the general class of unsecured creditors, where that treatment may be necessary to make the plan feasible. Classification can, however, increase the complexity and costs of the insolvency proceedings, depending upon how many different classes are identified. An alternative approach to ensuring that creditors who should receive special treatment are not oppressed by the majority is to give those groups the opportunity to challenge the decision of the majority in court if they have not been treated in a fair and equitable manner. The fact that such a facility exists may operate to discourage majorities from making proposals that would unfairly disadvantage preferential creditors.

507. As to the treatment of dissenting creditors, it will be essential to provide a way of imposing an agreed plan upon a minority of dissenting creditors within a class in order to increase the chances of success of the reorganization. It may also be necessary, depending upon the mechanism that is chosen for voting on the plan and whether creditors vote in classes, to consider whether the plan can be made binding upon dissenting classes of creditors and other affected parties.

508. To the extent that a plan can be approved and enforced upon dissenting parties, there may be a need to ensure that the content of the plan provides appropriate protection for those dissenting parties and, in particular, that their rights cannot be unfairly affected. So, for example, the law might provide that a dissenting class could not be bound unless assured of certain treatment. If the creditors are secured, the treatment required may be that the creditor receives payment of the value of its security interest, while in the case of unsecured creditors it may be that any junior interests, including equity holders, receive nothing. To the extent that the approval procedure results in a significant impairment of the claims of creditors and other affected parties without their consent (particularly secured creditors), there is a risk that the willingness of creditors to provide credit in the future may be undermined.

The mechanism for approval of the plan, and the availability of appropriate safeguards, is therefore of considerable importance to the protection of these interests.

**(a) Procedures for approval**

509. Many insolvency laws provide for a special meeting of creditors to be called for the purpose of voting on the reorganization plan, and require that the plan (and the information or disclosure statement where that document is also to be provided) be made available to the creditors and other interested parties who are entitled to vote within a certain period of time before that meeting is called. Some laws provide that voting should occur in person at a meeting of creditors, while other laws also provide that voting may take place by mail or by proxy. To facilitate voting and recognize the increasing use of electronic means of communication, it may be desirable to permit voting to take place in person, by proxy and by electronic means.

510. Other issues to be considered with regard to approval of the plan include whether creditors and other interested parties should vote in classes according to their respective rights; the types of claims (in terms of admission or provisional admission of those claims) that will be considered in determining whether the requisite voting majority has been reached, whether secured creditors are required to vote; whether the votes of priority claims will be considered in determining the requisite majority; which interested parties other than creditors are entitled to vote on the plan; and the manner in which abstaining or non-participating creditors will be treated. These issues are discussed in the following paragraphs. With respect to the last issue, some laws, for example, treat abstaining or non-participating voters as votes not to accept a plan. Such an approach may have the effect of disenfranchising those creditors who did participate and vote on approval of the plan, and may in practice make it very difficult to obtain approval of a plan. As an alternative, many countries adopt the approach of calculating the percentage of support on the basis of those parties actually participating in the voting on the basis that absentees and abstaining voters can be considered to have little interest in the proceedings. This approach may result in a potentially small and unrepresentative group of creditors affecting the course of the reorganization, particularly in view of the prevalence of creditor apathy. A balanced approach that facilitates approval of the plan, ensures a sufficient level of creditor support to enable implementation and avoids abuse is required. This can be facilitated, whichever of the approaches discussed above is adopted, by requiring provision of adequate notice, to creditors and other interested parties, especially where they are non-residents, as well as by adopting mechanisms for voting that do not require personal attendance, such as the use of proxies and electronic means.

511. Some insolvency laws also make use of presumptions to simplify voting procedures. Where, for example, a plan cancels a creditor's claim or an owner's equity interest (and that party receives nothing under the plan), a vote by that party against the plan can be presumed. In contrast, where a plan leaves a claim unimpaired or provides that it will be paid in full, a vote in favour of the plan can be presumed. The use of such presumptions may also reduce the need to provide notice and information to relevant creditors and other interested parties.

**(b) Approval by secured and priority creditors**

512. In many cases of insolvency, secured claims will represent a significant portion of the value of the debt owed by the debtor and different approaches can be taken to approval of the plan by secured and priority creditors. As a general principle, however, the extent to which a secured creditor is required to vote will depend upon the manner in which the insolvency regime treats secured creditors, the extent to which a reorganization plan can affect the security interest of the secured creditor, and the extent to which the value of encumbered assets will satisfy the secured creditor's claim.

513. Under one approach, where the insolvency law does not affect secured creditors and, in particular, does not preclude them from exercising their rights against the encumbered assets, there is no need to give these creditors the right to vote since their security interests will not be impaired by the plan. Priority creditors are in a similar position under this approach—the plan cannot impair the value of their claims and they are entitled to receive full payment. The limitation of this approach, however, is that it may reduce the chances for a successful reorganization, especially where the encumbered assets are vital to the success of the plan. If the secured creditor is not bound by the plan, the election by the secured creditor to exercise its rights, such as by repossessing and selling the encumbered asset, may make reorganization of the business impossible to implement. Similarly, in certain circumstances, the only way in which the plan may succeed is to provide that priority creditors receive less than the full value of their claims upon approval of the plan. Thus, the prospects for reorganization may improve if priority creditors will accept payment over time and if secured creditors will acquiesce when the terms of the secured debt are modified over time. If they are not included in the plan and required to vote on proposals affecting their rights, modification of those rights cannot be achieved.

514. To the extent that the value of the encumbered asset will not satisfy the full amount of the secured creditor's claim, a number of insolvency laws provide for those secured creditors to vote with ordinary unsecured creditors in respect of the unsatisfied portion of the claim. In some legal systems, this raises difficult questions of valuation in order to determine whether and to what extent a secured creditor is in fact secured. For example, where three creditors hold security over the same asset, the value of that asset may only support the claim first in priority and part of the second in priority. The second creditor therefore may have a right to vote only in respect of the unsecured portion of its claim, while the third creditor will be totally unsecured. The valuation of the asset is therefore crucial to determining the extent to which secured creditors are secured and thus whether or not they are required to vote as unsecured creditors with respect to any portion of their claim.

515. There are a variety of different approaches to secured creditor voting on a reorganization plan. Some insolvency laws provide for secured and priority creditors to vote as separate classes on a plan that would impair the terms of their claims, or provide for them to otherwise consent to be bound by the plan. Adopting an approach that allows for secured creditors to vote as a separate class recognises that the respective rights and interests of secured creditors differ from those of unsecured creditors. The same rationale is true for priority creditors. In many cases, however, the rights of secured creditors will differ from each other and it may not be feasible to require all secured creditors to vote in a single class. In such cases,

some laws provide that each secured creditor forms a class of its own. Where secured creditors do vote, the requisite majority of a class of secured creditors would generally be the same as that required for approval by unsecured creditors, although there are examples of laws that require different majorities depending upon the manner in which secured creditors rights are to be affected by the plan (e.g. a three-quarter majority is required where the maturity date is to be extended and a four-fifths majority where the rights are otherwise to be impaired).

516. Where secured creditors vote in classes, some insolvency laws provide that to the extent that the requisite majority of the class votes to approve the plan, dissenting members of the class will be bound by the terms of the plan, subject to certain protections. Under those laws, the protections available to dissenting secured creditors may include that they are entitled to receive at least as much as they would have received in liquidation and only where that occurs can they be bound by the plan, or that they may be bound if the plan makes provision for them to be paid in full to the extent of the value of their security interest, with interest at a market rate, within a certain period of time. Some insolvency laws also provide that the court has the power to order that secured creditors are bound by the plan, provided it is satisfied as to certain conditions. These conditions may include that enforcement of the security interest by the secured creditor will have a material adverse effect on achieving the purposes of the plan; that the security interests of the secured creditor will be sufficiently protected under the plan; and that the position of the secured creditor will not further deteriorate under or as a result of the plan (for example, payments of future interest will be made and the value of the encumbered asset securing the security interest will not be affected). Other insolvency laws provide that the plan cannot be imposed upon any secured creditors unless they consent to such imposition.

517. In determining which approach should be taken to this issue, it will be important to assess the effect of the desired approach upon the availability and cost of secured transaction financing and to provide as much certainty and predictability as possible, balancing this against the objectives of insolvency law and the benefits to an economy of successful reorganization.

**(c) Approval by ordinary unsecured creditors**

518. Different mechanisms may be used to ensure that ordinary unsecured creditors have an effective means for voting on a plan. Whichever mechanism is chosen it is desirable that it be as simple as possible and be clearly set out in the insolvency law to ensure predictability and transparency.

*(i) Classes of unsecured creditors*

519. A number of insolvency laws do not provide for unsecured creditors to be divided into different classes, rather they vote together as a single group.

520. Countries that have established classes for secured and priority creditors often also provide for the division of ordinary unsecured creditors into different classes based upon their varying economic interests. The creation of these classes is designed to enhance the prospects of reorganization in at least three respects by providing: a useful means of identifying the varying economic interests of unsecured creditors; a framework for structuring the terms of the plan; and a means for the court to utilize

the requisite majority support of one class to make the plan binding on other classes which do not support the plan. Since the creation of different classes has the potential to complicate the voting procedure, it may be desirable only where there are compelling reasons for special treatment of some ordinary unsecured creditors, such as a large number of creditors that lack a common economic interest. Criteria that may be relevant in determining commonality of interest may include: the nature of the debts giving rise to the claims; and the remedies available to the creditors in the absence of the reorganization plan, including the extent to which the creditors could recover their claims by exercising those remedies. Where there is a small number of unsecured creditors or where their interests are similar, there may be no need for creditors to vote on approval of the plan in different classes, thus simplifying the voting procedure.

(ii) *Determination of classes*

521. Some insolvency laws specify the manner in which classes of ordinary unsecured creditors or claims are determined for the purposes of approval of the reorganization plan. One approach is for the plan to place claims or interests into a particular class on the basis of common interest or substantial similarity or on the basis of the value of the claim. Where the test is commonality or similarity of interest, the party proposing the plan may have some flexibility in assigning claims to a particular group. Other approaches provide for the insolvency representative to make recommendations to the court before the creditors vote on approval, or for the classes to be determined in the first instance by the debtor, who will have some limited flexibility as to the composition of each class; unsecured creditors who are dissatisfied with the composition of the class can seek to have the issue determined by the court.

(d) **Approval by equity holders**

522. Some insolvency laws provide for the approval of reorganization plans by equity holders, at least where the corporate form, the capital structure or the membership of the debtor will be affected by the plan. Equity holders may also be expected to vote in cases where they will receive a distribution under the plan. Where the debtor's management proposes a plan, the terms of the plan may already have been approved by the equity holders (depending upon the structure of the debtor in question, this may be required under its constitutive instrument). This is often the case where the plan directly affects equity holders, such as by providing for debt-for-equity conversions, either through the transfer of existing shares or the issuance of new shares.

523. In circumstances where the insolvency law permits creditors or an insolvency representative to propose a plan, and the plan contemplates debt-for-equity conversion, some countries allow the plan to be approved by creditors over the objection of equity holders, irrespective of the terms of the constitutive instrument of the debtor. Such plans may result in the interests of existing equity holders being entirely displaced in the new business without their consent.

(e) **Related persons**

524. Some insolvency laws provide that related persons should not vote with other creditors on approval of the plan or that their votes will not count for certain purposes, such as determining that an impaired class of creditors has accepted the

plan (when that is a requirement of approval). Many insolvency laws, however, do not include provisions dealing specifically with this issue of related persons. Where the insolvency law makes no special provision, related persons should vote in the same manner as other creditors. They will generally, however, be subject to the provisions of non-insolvency law in respect of their personal dealings with the debtor and its business.

**(f) Requirements for approval of the plan**

525. Many insolvency laws identify the minimum threshold of support required from creditors for a plan to be approved. The requisite majority can be calculated in a number of different ways, depending upon whether or not creditors vote in classes, and how those classes are treated in determining the majority, and as discussed above (II.5(a)), whether the insolvency law requires a majority of creditors voting or of all creditors.

*(i) Where voting is not conducted in classes*

526. Where creditors do not vote in classes, the majority may be fixed by reference to the support of a proportion or percentage of the value of claims or a number of creditors, or a combination of both. Some laws require, for example, that a plan be supported by at least two-thirds or three-quarters of the total value of the debt and more than one-half or two-thirds of the number of creditors. While these proportions generally apply to those creditors actually voting on approval of the plan, there are laws which determine these proportions by reference to the total value of debt and total number of creditors, irrespective of whether or not they vote. Other combinations are also used.

*(ii) Where voting is conducted by class*

527. Where creditors do vote in classes, a wide variety of different approaches are taken to determining when a plan will be approved. These approaches can be somewhat complex, involving requirements both for approval by a particular class and for approval among all the classes, with majorities determined by reference, in some cases, only to those creditors actually voting, and in others to the total number of creditors, whether voting or not (see 5(a) above).

*- Majority within a particular class*

528. Some insolvency laws require approval by a majority of creditors of a class, where the requisite majority is based upon a percentage or proportion of the value of claims or a number of creditors, or a combination of both. Although increasing the difficulty of achieving approval, a procedure which includes both value of claims and number of creditors may be justified on the basis that it protects the collective nature of the proceedings. For example, if a single creditor holds a majority of the value, such a rule prevents that creditor from imposing the plan on all other creditors against their will. Equally, such a provision may prevent a large creditor from imposing its lack of support for the plan on other creditors to their detriment, although there are examples of laws that do provide creditors holding more than a certain percentage of the total value of claims with a power to veto approval or to force an improvement of the terms of the plan that will benefit all creditors. A voting procedure which combines the value of claims with a number of creditors

will also prevent a large number of very small creditors from imposing their decision on a few creditors who hold very large claims. Some insolvency laws include provisions to the effect that even where a majority of the number of creditors support a plan, where those creditors represent less than a certain percentage of value of the total claims (e.g. around 25 or 30 percent), the court will be reluctant to confirm the plan. This procedure may also be justified on the basis that it helps to ensure the support for the plan is sufficient to enable it to be successfully implemented.

*- Majority of classes*

529. Some laws require that all classes of creditors must support the plan for it to be approved. A few laws, however, enable support by some classes to make the plan binding on other classes that do not support the plan. For example, a simple majority of the classes may be required or, where less than a majority of classes support the plan, the plan may nevertheless be made binding on a dissenting class that does not support the plan, provided the court is satisfied certain conditions are met. One law, for example divides claims into three classes and provides that the plan must be approved by at least two of those classes, and that at least one of the approving classes would not recover the full amount of their claims if the debtor were to be liquidated. Another variation requires that at least one of the classes approving the plan will have its rights impaired under the plan, to ensure that the plan is not only supported by those creditors whose rights are not impaired. Other laws provide that support by classes of unsecured creditors cannot force approval of plan if secured creditors oppose the plan. This is discussed further under 7 and 8 below.

**6. Where a proposed plan cannot be approved**

**(a) Modification of a proposed plan**

530. Whichever voting mechanism is chosen, it is desirable that the insolvency law be sufficiently flexible to allow a plan submitted for approval of creditors and other interested parties, to be negotiated by those parties in the course of the voting procedure with a view to achieving wide support. Where such negotiation is not possible and creditors and other interested parties are restricted to voting on the plan as proposed without the possibility of change, the chances of achieving approval of that plan may be reduced. One approach to achieving this flexibility may be to allow a majority of creditors to vote to adjourn the decision meeting to enable further disclosure, if it appears that some further negotiation on a plan may produce a favourable result or to address unresolved disputes and issues. As with many other provisions of the insolvency law, however, it is desirable that that adjournment be available in limited circumstances or at least a limited number of times, with perhaps time limits being included to facilitate speedy resolution of the renegotiations and avoid abuse.

**(b) Failure to approve a plan**

531. In cases where a reorganization plan is not approved and re-negotiation and modification of the plan will not resolve the difficulties encountered, an insolvency law may adopt different approaches to the further conduct of the proceedings. Some insolvency laws provide that the failure by creditors to approve the plan should be

taken as an indication that they favour liquidation and the reorganization proceedings can be converted to liquidation (see also part one, chapter II.D; part two, chapter IV.A.14). This approach may operate to encourage debtors to propose an acceptable plan, subject to safeguards to prevent abuse in cases where liquidation is not in the interests of all creditors may be appropriate. Other insolvency laws provide that the reorganization proceedings should be dismissed. This approach has the disadvantage of leaving the debtor in a state of financial difficulty, where further debts may accrue and the value of the assets diminish, and postponing the commencement of the liquidation proceedings that may be inevitable.

#### **7. Binding dissenting classes of creditors**

532. As noted above, a few countries that provide for voting on approval of a plan by secured and priority creditors and for the creation of different classes of unsecured creditors also include a mechanism that will enable the support of one or more classes to make the plan binding on other classes (including, under some laws, classes of secured and priority creditors) which do not support the plan. This is sometimes referred to as a “cram-down” provision. Where such provisions are incorporated in the insolvency law, the law also generally includes conditions that are aimed at ensuring the protection of the interests of those dissenting classes of creditors. Since it is generally the court that is required to consider whether these conditions have been satisfied, they are discussed in the following section.

#### **8. Court confirmation of a plan**

533. Not all countries require the court to confirm a plan that has been approved by creditors; approval by the requisite majority of creditors is all that is required for the plan to be effective and dissenting creditors will be bound by virtue of the operation of the insolvency law. In those systems, the court will still have a role to play with regard to review of the plan where minority creditors or other interested parties, including the debtor, challenge the plan itself or the means by which it was procured. Other countries do require court confirmation of the approval for the plan to be effective and binding.

##### **(a) Challenges to approval of the plan**

534. Many insolvency laws provide for the approval of the plan by creditors to be challenged in the court. The manner in which a challenge will be heard may depend upon the mechanism for making the plan effective. If court confirmation of the plan is not required, for example, minority creditors or other interested parties, including the debtor, may raise their challenge with the court after the vote on approval. Where the insolvency law requires court confirmation of an approved plan, a challenge may be made at the confirmation hearing. The law will also need to address the parties that may challenge approval of the plan, and the timing of any challenge, particularly where the basis of the challenge is fraud and any time limits may need to be established by reference to the time of discovery of the fraud. The law will also need to address the consequences of a successful challenge to the plan, such as permitting further opportunities for consideration and approval of a plan, depending upon the basis on which the challenge succeeded, or converting the proceedings to liquidation.



535. A number of insolvency laws establish the grounds for challenging approval of the plan. These may include that approval of the plan was obtained by fraud (e.g. false or misleading information was given to creditors and other interested parties or material information was withheld with respect to the reorganization plan or the financial affairs of the debtor); that there was some irregularity in the voting procedure (e.g. related persons participated where this is not permitted under the insolvency law or the resolution approving the plan was not consistent with the interests of creditors generally); that there was some irregularity in the organization or conduct of the meeting at which the vote was taken (e.g. adequate notice of the meeting was not given); that the proposals contained in the plan were put forward for an improper purpose or that the plan contains provisions contrary to law; that the plan is not feasible (e.g. secured assets are required for successful implementation of the plan, but secured creditors are not bound by the plan and no agreement has been reached with relevant secured creditors concerning enforcement of their security interests); that the plan does not satisfy the requirements for protection of dissenting creditors within a class (e.g. they will not receive as much under the plan as they would have received in liquidation); that the proposals unfairly prejudice the interests of the objector; or that the treatment of claims in the plan does not conform to the ranking of claims under the insolvency law (unless there has been agreement to vary that ranking).

536. Since all creditors are likely to be prejudiced to some degree by reorganization proceedings, a level of prejudice or harm that exceeds the prejudice or harm suffered by other creditors or classes of creditors would generally be required to enable a creditor to successfully challenge approval. Where the creditor challenging the plan voted in favour of the plan, the grounds for challenge may be limited, for example, to fraud and other impropriety.

**(b) Steps required for court confirmation**

537. Where the insolvency law requires the court (or in some countries an administrative authority) to confirm a plan, it would normally be expected to confirm a plan that has been approved by the requisite majority of creditors (whether voting in classes or otherwise). Many countries enable the courts to play an active role in “binding in” creditors by making the plan enforceable upon a class of creditors that has not approved the plan. This may require the court to undertake a role that is in the nature of a legal formality; it does not require the court to examine the commercial basis upon which the plan was approved but rather to ensure that the approval of the plan was properly obtained (i.e., there is no evidence of fraud in the approval process) and that certain conditions were satisfied. These conditions may be similar to or the same as those relevant to a challenge to the plan, for example, that those classes of creditors objecting to the plan will share in the economic benefits of the plan; that dissenting classes of creditors will receive as much under the plan as they would have received in liquidation; that no creditor will receive more than the full value of their claim; that normal ranking of claims under the insolvency law is recognized by the plan; and that similarly ranked creditors are treated equally. Some insolvency laws permit classes of unsecured creditors that are not entitled to priority to consent, by vote of the requisite majority of the class, to ranking different from that applying to distribution in a liquidation under the insolvency law. A class of ordinary unsecured creditors that will not be paid in full might consent, for example, to a distribution to a class of subordinated claims or

equity holders. Claims and expenses which are administrative claims or are entitled to be paid in priority generally are required to be paid in full for a reorganization plan to be confirmed, except to the extent that the holder of the claim or expense agrees to different treatment. Some laws require the court to assess additional matters, such as whether the plan can be considered to be fair in respect of those classes whose interests are impaired by the plan but which nevertheless have accepted the plan.

538. Some insolvency laws also give the court the authority to reject a plan on the grounds that it is not feasible or impossible to implement from a practical rather than an economic point of view. Such an approach may be justified, for example, where secured creditors are not bound by the plan, but the plan does not provide for full satisfaction of their secured claims. The court may reject the plan in such a case if it considers that secured creditors will exercise their rights against the encumbered assets, thus rendering the plan impossible to perform. The risk of this occurring should be addressed in provisions relating to preparation and approval of the plan.

539. The more complex the decisions the court is required to make in terms of approval or confirmation, the more relevant knowledge and expertise is required of the judges, and the greater the potential for judges to interfere in what are essentially commercial decisions of creditors to accept or reject a plan. It is desirable, in particular, that the court not be asked to review the economic and commercial basis of the decision of creditors (including issues of fairness that do not relate to the approval procedure, but rather to the substance of what has been agreed) nor that it be asked to review particular aspects of the plan in terms of their economic feasibility unless it has the competence and experience to do so. For these reasons, it is desirable that the requirements for approval by creditors and confirmation by the court (where this is required) of the plan are carefully designed to minimise potential problems of the kind discussed here.

#### **9. Effect of an approved [and confirmed] plan**

540. Where the plan is approved by the requisite majority of creditors and, where required, confirmed by the court, insolvency laws generally provide that it will be binding upon all affected ordinary unsecured creditors, including creditors who voted in support of the plan, dissenting creditors and creditors who did not vote on the plan. Some insolvency laws also provide that the plan will bind directors, shareholders and members of the debtor, and other parties as determined by the court. Some insolvency laws stipulate that the parties who are bound will be prevented from applying to the court to have the debtor liquidated (except, in specific circumstances, such as where implementation fails or the debtor fails to perform its obligations as required under the plan), to start or continue legal proceedings against the debtor or to pursue enforcement without approval of the court. Some laws also provide that once the plan is approved by creditors and confirmed by the court (where that is required), the property of the insolvency estate returns to the control of the debtor for implementation of the plan and a debtor may obtain a discharge from debts and claims pursuant to the plan.

#### **10. Challenges to a plan after court confirmation**

541. Many of those insolvency laws that require confirmation by the court provide for the plan to be challenged in the court subsequent to the confirmation hearing (in

some cases within a specified time period). On the basis that the court is required to be satisfied as to a number of conditions before confirming a plan, the grounds for challenge after confirmation could be narrower than the grounds for challenge at the time of confirmation and be limited, for example, to fraud. Where an insolvency law permits such a challenge after confirmation, it may be desirable to specify a time period after discovery of the fraud within which such a challenge can be brought, and to specify who may bring such a challenge. Where a challenge to a plan that has already been confirmed is successful, an insolvency law may adopt different options. For example the plan may be set aside and the proceedings converted to liquidation or the debtor be left in its state of financial difficulty and the assets returned to its control. The latter approach does not resolve the debtor's financial difficulty and may simply delay commencement of liquidation proceedings, leading to further diminution of the value of the debtor's assets before those proceedings are finally commenced. In determining the most appropriate action to be taken in circumstances where a challenge is successful, consideration will need to be given to the extent to which the plan has already been implemented and how steps taken in the implementation, such as payments to creditors, are to be treated.

#### **11. Amendment of a plan after approval by creditors**

542. An insolvency law may include limited provision for a plan to be modified after it has been approved by creditors (and both before and after confirmation where that is required) if its implementation breaks down or it is found to be incapable of performance, whether in whole or in part, and if the specific problem can be remedied. Of those insolvency laws that allow modification, some provide for the plan to be modified only if the modifications proposed will be in the best interests of creditors. Other laws provide that the plan can be modified if circumstances warrant the modification and if the plan, as modified, continues to satisfy the requirements of the insolvency law concerning, for example, content, classes of creditors and notice to creditors. Generally, any party in interest will be permitted to propose modification of a plan at any time. The only limitation that may apply in terms of timing relates to court approval of a modification. Such a requirement necessitates that the proceedings are still open and the court has jurisdiction. If proceedings are concluded after approval (and confirmation) of a plan, approval of the proposed amendment by affected creditors may be sufficient, unless some other requirement is imposed.

543. Depending upon the nature of the modification it may not be necessary to obtain the approval of all classes of creditors since in some cases obtaining this approval may prove difficult. Alternative approaches may include permitting small modifications to be approved by the court or by the creditors affected by the modification; providing that creditors who supported approval of the plan be notified of the proposed modification and permitted to object to that modification within a specified time period or otherwise be deemed to have accepted the modification. The same approach may be taken to creditors who did not approve of the plan. Where the modification proposed is significant, the approval of all creditors may be required. Those insolvency laws that require court confirmation of the plan may also require modifications to satisfy the rules or conditions relating to confirmation.

544. Whichever approach is adopted, it is desirable that the insolvency law not only require the giving of notice to relevant creditors (whether all creditors or only affected creditors) and specify the party responsible for giving that notice, but also the disclosure of information relevant to the failure of the plan and the proposed modification. Where the court has confirmed the original plan, it may also be required to confirm the modification to the plan. Where the requisite approval for the proposed modifications is not or cannot be obtained, it is desirable that the insolvency law addresses the consequences. These might be similar to those discussed above in respect of failure of creditors to approve the plan and successful challenges to the plan, taking into account the steps that already may have been taken in implementing the plan and the treatment to be afforded to payments made, contracts continued and so forth.

## 12. Implementation of a plan

545. Many plans can be executed by the debtor without the need for further intervention by the court or the insolvency representative. This is particularly so in the case of a debtor-in-possession reorganization, and under those laws that provide for the proceedings to conclude once a plan becomes effective. Under other laws that do not provide for the proceedings to conclude at that time, but rather when the plan has been fully implemented, it may sometimes be necessary for the implementation to be supervised or controlled by an independent person. Several insolvency laws provide that the court has an ongoing role in supervision of the debtor after approval and confirmation of the plan, pending completion of implementation of the plan. This may be important where issues of interpretation of the performance or obligations of the debtor or others arise. Some countries provide for the court to authorize continued supervision of the affairs of the debtor, to varying degrees, by a supervisor or insolvency representative after approval of the plan. A further approach permits creditors to appoint a supervisor or representative to oversee implementation of the plan.

## 13. Where implementation fails

546. Where the debtor defaults in performing its obligations under the plan or implementation of the plan breaks down for some other reason, insolvency laws adopt a number of different approaches to the consequences. Some insolvency laws provide that the court can terminate the plan and convert the proceedings to liquidation. Other laws provide that the plan will only be terminated in respect of the specific obligation breached (it otherwise remains valid). The creditor in question will not be bound by the plan and will have its claim restored (in the event that it had agreed to receive a lesser amount under the plan) to the full amount. In some cases, this will only occur where the debtor has fallen significantly into arrears<sup>91</sup> in the performance of its obligations under the plan. In some countries, the consequences of default may be set out in the plan itself.

547. A further approach may be to regard the insolvency proceedings as at an end and allow creditors to pursue the remedies otherwise available under the law. As already discussed, this approach does not resolve the financial difficulties of the

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<sup>91</sup> In one law, this requires a demand from the creditor for payment of the due liability and failure by the debtor to comply within a minimum period of time of at least two weeks.

debtor and could lead to a race for assets that the commencement of collective proceedings was intended to avoid. A compromise approach may be to allow the proposal of a different plan by creditors within a specified deadline and only in situations where no acceptable plan can be prepared within that deadline would liquidation follow. It must be recognized that at some point the balance between achieving the best outcome for all creditors and achieving what is feasible tips in favour of pursuing what is feasible, and it is desirable that an insolvency law be sufficiently flexible to allow this to occur.

#### **14. Conversion to liquidation**

548. A number of circumstances may arise in the course of a reorganization proceeding where it will be desirable for an insolvency law to provide a mechanism to convert the proceedings into liquidation. The principal grounds for conversion would be failure to propose or approve a reorganization plan or to approve proposed modifications to the plan; failure to obtain confirmation (where confirmation by the court is required); a successful challenge to an approved or confirmed plan; a majority vote by creditors to terminate a reorganization at a meeting of creditors; or material or substantial default by the debtor of its obligations under the plan. It may also be appropriate to consider conversion where it is determined that there is no reasonable likelihood of the business being successfully reorganized; where it is apparent that the debtor is misusing the reorganization process either by not cooperating with the insolvency representative or the court (e.g. withholding information) or otherwise acting in bad faith (e.g. making fraudulent transfers); where the business continues to incur losses during the reorganization period; or where administrative expenses are not paid (see also chapter I.B.8). Some laws also impose an obligation on the insolvency representative to terminate its mandate to administer reorganization proceedings as soon as it is evident that reorganization will not be possible, in order to preserve value for creditors. Making provision in the insolvency law for reorganization proceedings to be converted to liquidation will provide predictability as to the ultimate resolution of the proceedings, although it may lead to further delay and diminution of value if the liquidation proceedings are required to commence as if they were new proceedings, rather than being based on the original application.

549. Where reorganization proceedings are converted to liquidation, an insolvency law will also need to consider the status of any actions taken by the insolvency representative prior to approval of the plan; the continued application of the stay, particularly to secured creditors when the insolvency law contains a time limit relevant to commencement (see chapter II.B.3(c)); the treatment of payments made in the course of the implementation of the plan prior to a conversion; and the treatment of creditor claims that have been compromised in the reorganization. Payments made in the course of the reorganization may need to be protected from the operation of avoidance provisions. Claims that have been compromised in the reorganization may be reinstated to full value in any subsequent liquidation. The issue of failure of implementation may also be addressed in the reorganization plan, which may specify the rights of creditors in that event. Such an approach simplifies the question of treatment of those claims and avoids potentially difficult issues of applicable law.

550. Where the insolvency law permits conversion, a related question is how conversion can be triggered; whether it should be automatic once certain conditions are fulfilled or require application to the court by the insolvency representative or creditors. Because it is the party that, after the debtor or its management, has the greatest knowledge of the debtor's business, and so often learns at an early stage whether or not the debtor's business is viable, the insolvency representative can play a key role in the conversion process. In addition, it may be reasonable to allow creditors or the creditor committee (where one has been appointed), to request the court to convert the proceedings on similar grounds. The court could also be given the power to convert on its own motion where certain conditions are met.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions relating to the reorganization plan is to:

- (a) facilitate the rescue of businesses subject to the law, thereby preserving employment and, in appropriate cases, protecting investment;
- (b) identify those businesses that are capable of reorganization;
- (c) maximize the value of the estate;
- (d) facilitate the negotiation and approval of a reorganization plan and establish the effect of approval, including a mechanism to make a plan binding on the debtor, all creditors and other interested parties;
- (e) address the consequences of a failure to propose an acceptable reorganization plan or to secure approval of the plan by creditors, including conversion of the proceedings to liquidation in certain circumstances;
- (f) provide for the implementation of the reorganization plan and the consequences of failure of implementation.

### **Contents of legislative provisions**

#### *Preparation of the plan—timing*

(123)(a) Where a plan is required, the law should specify that the plan is proposed on or after the making of an application to commence insolvency proceedings, or within a specified time period after commencement of the insolvency proceedings:

- (i) the time period should be fixed by the law.
- (ii) the court should be authorized to extend the time period in appropriate circumstances.

(b) The law should also address the issue of timing where liquidation proceedings are converted to reorganization proceedings.

#### *Proposal of the plan—parties permitted*

(124) The law should identify the parties permitted to propose a plan for approval.

(125) In providing for the proposal of a plan, the law should adopt a flexible approach that potentially involves all parties central to the insolvency proceedings, i.e. the debtor, the creditors and the insolvency representative. The law may combine different elements:

(a) An exclusive period may be given to one party to propose a plan. To encourage debtors to apply for commencement of proceedings at an early stage of financial difficulty, it should be the debtor that is given that opportunity. That party may be required to consult with other parties in order to ensure proposal of an acceptable plan;

(b) Where no plan is forthcoming within the exclusive period, other parties, such as the insolvency representative, creditors or the creditors committee in collaboration with the insolvency representative, may be given the opportunity to propose a plan, or the court may extend the exclusive period if the party which has the exclusive period can show that an extension is warranted.

#### *Preparation of a disclosure statement*

(126) The law should require a plan submitted for the consideration of creditors and equity holders to be accompanied by a disclosure statement that will enable an informed decision about the plan to be made. The statement should be prepared by the same party that proposes the plan and be submitted to creditors and equity holders at the same time as submission of the plan.

#### *Submission of the plan and disclosure statement*

(127) The law should provide a mechanism for submission of the plan and disclosure statement to creditors and equity holders required to approve the plan.

#### *Content of the plan*

(128) The law should specify the minimum contents of a plan, which may include:

- (a) detail as to the classes of creditors and the treatment provided for each class by the plan (e.g. how much they will receive and the timing of payment);
- (b) the terms and conditions of the plan, including:
  - [(i) treatment of encumbered assets;]
  - (ii) treatment of contracts, including labour contracts;
  - (iii) the debtor's role in implementation of the plan, including control over assets;
- (c) means for the implementation of the plan which may include:
  - (i) the possibility of sale of all or any part of the debtor's business;
  - (ii) proposed changes in the capital structure of the debtor's business;
  - (iii) amendment of the instrument constituting the debtor;
  - (iv) merger or consolidation of the debtor with one or more persons;
  - (v) [modification of terms of security interests, including] extension of a maturity date or a change in an interest rate or other term;

- [(vi) continued use of encumbered assets;]
- (vii) distribution of all or any part of the assets of the estate among those having an interest in those assets;
- (viii) identification of those responsible for future management of the debtor;
- (ix) supervision of the implementation of the plan.

*Content of disclosure statement*

(129) The law should specify that the disclosure statement include:<sup>92</sup>

- (a) information relating to the financial situation of the debtor including asset and liability and cash flow statements;
- (b) a comparison of the treatment afforded to creditors by the plan and what they would otherwise receive in liquidation;
- (c) the basis upon which the business would be able to keep trading and could be successfully reorganized;
- (d) information showing that, having regard to the effect of the plan, the assets of the debtor will exceed its liabilities and that adequate provision has been made for satisfaction of all obligations provided for in the plan; and
- (e) information on the voting mechanisms applicable to approval of the plan.

*Voting mechanisms*

(130) The law should establish a mechanism for voting on approval of the plan. The mechanism should address the creditors who are entitled to vote on the plan; the manner in which the vote will be conducted, either at a meeting convened for that purpose or by mail or other means, including electronic means and the use of proxies; and whether or not creditors should vote in classes according to their respective rights. The law should permit a plan that is submitted to creditors for approval to be negotiated in the course of that approval process.

*Approval of the plan by members of a particular class*

(131) The law should specify the majority required for approval of the plan by a particular class of creditors. Where the required majority supports the plan, that class will be regarded as approving the plan. The majority should be calculated by reference to those actually voting, whether in person, by proxy or by other means.

(132) A majority based on unanimity or a simple majority of the number of those voting is not recommended. Alternative approaches may include requiring a combination of the number of those voting and the amount of claims, in proportions such as a simple majority of the number of those voting combined with a simple or greater (for example, two-thirds) majority in amount of the claims of those voting.

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<sup>92</sup> Where the insolvency representative does not prepare, or is not involved in the preparation of, the plan and the statement, the insolvency representative should be required to comment on both instruments.



*Approval by classes*

(133) Where voting on approval of the plan is conducted by reference to classes, the law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. [Different approaches may be taken, including requiring approval by a specified majority of the classes or approval by all classes.]

(134) Where the law does not require approval by all classes, the law should address the treatment of those classes that do not vote in support of a plan that is otherwise approved by the requisite [classes] [majority of classes].

*Failure to approve a plan*

(135) The law should specify the consequences of a failure to secure approval of a plan by the requisite majority of creditors.

*Binding effect of a plan*

(136) The law should specify that a plan will bind the debtor, creditors, and other interested parties, on the basis of either:

- (a) approval by the requisite majority of creditors; or
- (b) approval under (a) and confirmation of the approved plan by the court.

*Continuing use of encumbered assets*

[(137) The law may provide that if secured creditors do not support a plan and the encumbered assets are required for the reorganization, the court may order that the assets may continue to be used in the reorganization, subject to protection of the interests of the secured creditor.]

*Confirmation of an approved plan*

(138) Where the law requires court confirmation of an approved plan, the court should confirm the plan if:

- (a) the approval process was properly conducted;
- [(b) creditors have been treated fairly and equitably;]
- (c) creditors will receive at least as much under the plan as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;
- (d) the plan does not contain provisions contrary to the general law;
- [(e) administrative claims and expenses and claims which are entitled to priority will be paid in full except to the extent that the holder of the claim or expense agrees to different treatment;]and
- [(f) the treatment of claims<sup>93</sup> in the plan conforms to the ranking of claims under the law, except to the extent that affected creditors have agreed to vary that ranking.<sup>94</sup>]

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<sup>93</sup> Including for administrative costs and expenses.

*Challenges to approval (where there is no requirement for confirmation)*

(139) Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the law should permit interested parties, including the debtor, to challenge the approval of the plan. The law should specify criteria against which a challenge can be assessed which should include:

- (a) whether the grounds set forth in recommendation (142) are satisfied; and
- (b) fraud, in which case paragraphs (a) to (c) of recommendation (144) should apply.

*Challenges to a confirmed plan*

(140) The law should permit a confirmed plan to be challenged on the basis of fraud. The law should specify:

- (a) a time limit for bringing such a challenge by reference to the time of discovery of the fraud;
- (b) the party that may bring such a challenge; and
- (c) that the challenge should be brought to the court.

(141) The law should specify the consequences of a successful challenge under recommendations (139) and (140).

*Amendment of the plan*

(142) The law should permit amendment of a binding plan and specify the parties that may propose amendments and the time at which the plan may be amended.

*Approval of amendments*

(143) The law should establish the mechanism for approval of amendments to the plan. That mechanism should require notice to be given to creditors and other affected parties; specify the party required to give notice; require the approval of affected creditors and require the satisfaction of the rules for confirmation (where confirmation is required). The law should also specify the consequences of failure to secure approval of proposed amendments.

*Supervision of implementation*

(144) The law may establish a mechanism for supervising implementation of the plan, which may include supervision by the court, by a court appointed supervisor, by the insolvency representative, or by a creditor-appointed supervisor.<sup>95</sup>

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<sup>94</sup> The court should satisfy itself that if one or more creditors are to receive less favourable treatment than prescribed for their rank under the law, those creditors have consented to that treatment.

<sup>95</sup> Where the proceedings involve a debtor-in-possession, or where the proceedings conclude on approval of the plan, it may not be necessary to appoint a supervisor.

*Conversion to liquidation*

(145) The law should provide that the court may convert reorganization proceedings to liquidation where:

[(a) a plan is not proposed within any time limit specified by the law and no extension of time is approved by the court;]

[(b) an application for conversion is made by the insolvency representative or creditors;]

(c) a proposed plan is not approved;

(d) an approved plan is not confirmed (where the law requires confirmation);

(e) an approved or a confirmed plan is successfully challenged;

(f) there is substantial breach of the terms of the plan.

**B. Expedited reorganization proceedings****1. Introduction**

551. As discussed above in part one of the Guide, reorganization can take one of several forms including reorganization conducted under the formal supervision of a court or administrative body (the main form of reorganization discussed in the Guide) and informal (i.e. in the sense of being conducted out-of-court) negotiation and acceptance of a plan (referred to in this discussion as voluntary restructuring negotiations and agreements) which requires little or no court involvement and essentially depend upon the agreement of the parties involved. Because many of the costs, delays and procedural and legal requirements of formal reorganization proceedings can be avoided where voluntary restructuring negotiations are used, this type of negotiation often can be the most cost efficient means of resolving a debtor's financial difficulties, although it may not be effective in all instances of financial difficulty because it depends upon certain pre-conditions, discussed below. Nevertheless, these negotiations can be a valuable tool in the range of insolvency solutions available to a country's commercial and business sector. Encouraging the use of such negotiated solutions need not stem from the fact that a country's formal insolvency system is poor, inefficient or unreliable, but rather from the advantages such solutions can offer as an adjunct to a formal insolvency system which delivers fairness and certainty.

552. Reaching agreement through voluntary restructuring negotiations is often impeded by the ability of individual creditors to take enforcement action and by the need for unanimous creditor consent to alter the repayment terms of certain existing classes of debt. These problems are magnified in the context of complex, multinational businesses, where it is especially difficult to obtain consents from all relevant parties. To facilitate the successful outcome of these negotiations, the International Federation of Insolvency Professionals (INSOL) developed the *Principles for a Global Approach to Multi-Creditor Workouts*. The *Principles* are designed to expedite negotiation and increase the prospects of success by providing guidance to diverse creditor groups about how to proceed on the basis of some common agreed rules.

553. Voluntary restructuring negotiations can also be impeded by a minority of affected creditors who may refuse to agree to a solution that is in the best interests of most creditors in order to take advantage of their position to extract better terms for themselves at the expense of other parties (often referred to as “holding out”). Where these hold-outs occur, the voluntary agreement can only be implemented if by some means the contractual rights of these dissenting creditors can be modified without their consent. Under most existing legal systems, such a modification of contractual rights requires the voluntary agreement to be converted to full court-supervised reorganization proceedings under the insolvency law, involving all creditors and including standards of treatment that appropriately protect the interests of dissenting creditors. Timing is typically critical in business restructuring and delay (usually inherent in full court-supervised insolvency proceedings) can frequently be costly or even fatal to an effective solution. It is therefore important that the court be able to take advantage of the voluntary negotiations and consents to a restructuring plan obtained prior to the commencement of reorganization proceedings under the insolvency law and that the insolvency law permits the court to expedite those reorganization proceedings, referred to in this section as expedited reorganization proceedings.

## **2. Creditors typically involved in voluntary restructuring negotiations**

554. Voluntary restructuring negotiations typically involve the debtor and one or more classes of creditors, such as lenders, bondholders and shareholders. They also frequently involve major non-institutional creditors, typically where such creditors’ involvement is so considerable that an effective restructuring is not possible without their participation. These types of creditors often find it advantageous to participate in these negotiations because there is a potential to reduce the loss that they would otherwise suffer under full court-supervised insolvency proceedings.

555. The limited classes of creditors that would normally participate in voluntary restructuring negotiations, and thus in an expedited proceeding, makes an agreement easier to accomplish than full court-supervised reorganization, which typically affects all claims. It is usual in voluntary restructuring negotiations for these types of non-institutional creditors to continue to be paid in the ordinary course of business. On that basis, these creditors are not likely to have any objection to the proposed restructuring. Where, however, the rights of those creditors are to be modified, their agreement to the proposed modifications would be required.

## **3. Proceedings to implement a voluntary restructuring agreement**

556. An insolvency law can provide for recognition of a plan negotiated and agreed before commencement of reorganization proceedings under the insolvency law and for expedition of those proceedings. Where it does so, consideration will need to be given to defining the debtors to whom it might apply and the parties that can be affected by such proceedings.

### **(a) Eligible debtors**

557. Expedited reorganization proceedings may be available on the application of any debtor eligible to commence proceedings under the general reorganization provisions of an insolvency law.

558. Where the insolvency law establishes an obligation to commence insolvency proceedings if the debtor meets specified criteria concerning its financial position (e.g. that it is insolvent), it may be necessary to provide specifically that the commencement of expedited proceedings satisfies this obligation. Alternatively the insolvency law may provide a temporary moratorium which will enable the debtor to avoid meeting those criteria (and thus avoid the sanctions for failure to meet the obligation to apply for commencement).

**(b) Obligations affected**

559. As noted above, the types of obligations typically involved in voluntary restructuring negotiations relate to borrowed money indebtedness, both institutional and public, whether secured or unsecured, and other similar financial obligations. Secured debt could also be included in such negotiations with the agreement of the secured creditors. Indebtedness held by other creditors, such as trade creditors, preferential creditors such as tax and social security authorities, and employees, generally is not included because of the difficulty of obtaining necessary approvals to adjustment of their claims<sup>96</sup> and these creditors continue to be paid in the ordinary course of business. However, such creditors could be included, particularly where their rights are to be modified in the reorganization, provided all the relevant safeguards applicable under the insolvency law were observed. The specific obligations to be affected in any given case would be those identified in the plan which is to be confirmed under this type of proceeding.

**(c) Application of the insolvency law**

560. In addition to identifying eligible debtors and determining who may apply for commencement of this type of proceeding, an insolvency regime that permits expedited proceedings will need to identify those provisions of the insolvency law applicable to full court-supervised proceedings that will apply to these proceedings, particularly if any changes are to be made in the manner in which they apply. So, for example, the provisions which would generally apply to this type of proceedings in the same manner as for full court-supervised proceedings (unless specifically modified) might include provisions on: application procedures; commencement; application of the stay; requirements for preparation of a list of all creditors (in order to inform the court, and provide notice and certainty as to who is affected by the plan and who is not); requirements for approval of the plan (including notice to affected creditors, determination of classes of creditors, creditor committees, criteria and majorities required for approval); effect and confirmation of the plan; issues relating to implementation of the plan and discharge of claims. Where implementation of a plan confirmed under an expedited proceeding fails, the insolvency law will need to consider the consequences of that failure and in particular, whether they should be the same as for failure of plan approved in formal proceedings, (discussed in chapter IV.A.13 and 14), and whether special provision should be made in respect of payments already made in the course of implementation.

561. Provisions of the insolvency law that might not apply to expedited proceedings would include those relating to the requirement for general cessation of payments or

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<sup>96</sup> These trade claims could be restructured if the necessary majority approval could be obtained.

insolvency; appointment of the insolvency representative, unless the plan specifically provides for that appointment; submission of claims; requirements for notice and time periods for plan approval (where such provisions are included in the insolvency law); and voting on the plan. A further and important exception to the application of the insolvency law would be that, upon a showing of a likelihood of successful confirmation of the reorganization plan, the court could authorize creditors not affected by the plan to continue, during the proceedings, to be paid in the ordinary course of business.

562. The application for commencement of expedited proceedings may need to be somewhat different to an application for full court-supervised proceedings to take account of the different background considerations. The application could include, for example, additional information concerning the negotiations that have already been conducted and the pre-commencement solicitation and voting of affected classes of creditors, as well as the protections afforded to dissenting creditors within accepting classes. An insolvency law may also need to address the question of whether the application will function as an automatic commencement of the proceedings or whether the court will be required to consider the application; if court consideration is required, it is desirable that the time for such consideration be as brief as possible, particularly because the application is based upon negotiation and agreement and delay is detrimental not only to the debtor's business but also to implementation of the plan.

**(d) Expedition of the proceedings**

563. In order to take full advantage of the negotiated agreement and avoid the delays that may make that agreement impossible to implement, an insolvency law may need to consider how this type of proceeding can be handled more quickly than full court-supervised reorganization proceedings. For example, if a plan and other documentation that complies with the formal requirements of the insolvency law has been negotiated and is supported by a substantial majority, it may be possible for the court to order an immediate meeting or hearing as applicable, saving time and expense. It may also be possible for an exemption to be granted from part of the formal proceedings. For example, if a negotiated restructuring plan has been agreed to by a majority of creditors of a particular class—typically the institutional creditors—sufficient to satisfy the voting requirements of the insolvency law for approval of a reorganization plan and the rights of other creditors will not be impaired by the implementation of the plan, it might be possible for the court to order a meeting or hearing of that particular approving class of creditors only. Similarly, if the solicitation of votes of affected classes of creditors has been conducted in compliance with applicable laws governing such solicitation (including the disclosure requirements of applicable securities laws) it should be possible for the court to dispense with post-commencement solicitation procedures.

564. Even where the insolvency law provides for eligible cases to be treated expeditiously, it is highly desirable that it does not afford less protection for dissenting creditors and other parties than the insolvency law provides for dissenting creditors in full court-supervised reorganization proceedings. The procedural requirements for such expedited reorganization proceedings would therefore include substantially the same safeguards and protections as provided in full court-supervised reorganization proceedings.

565. Other laws may need to be modified to encourage or accommodate both voluntary restructuring negotiations and this type of expedited reorganization proceedings. Examples of those laws might include that expose directors to liability for trading during the conduct of informal reorganization negotiations; that do not recognize obligations for credit extended during such a period or subject those obligations to avoidance provisions; and that restrict conversion of debt to equity.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions relating to insolvency procedures which combine voluntary restructuring negotiations and acceptance of a plan with an expedited procedure conducted under the law for court approval of that plan is to:

(a) recognize that voluntary restructuring negotiations, which typically involve restructuring of the debt due to lenders and other institutional creditors and major non-institutional creditors where their participation is crucial to the restructuring, but not involving all categories of creditors, is a cost effective, efficient tool for the rescue of financially troubled businesses;

(b) encourage and facilitate the use of informal negotiation;

(c) develop a procedure under the law that will:

(i) preserve the benefits of voluntary restructuring negotiations where a majority of each affected class of creditors agree to a plan;

(ii) minimize time delays and expense and ensure that the plan negotiated and agreed in voluntary restructuring negotiations is not lost;

(iii) bind those minority members of each affected class of creditors and shareholders who do not accept the negotiated plan ;

(iv) be based upon the same substantive requirements, but shortened time periods, as reorganization proceedings under the law, including essentially the same safeguards;

(d) suspend, with appropriate safeguards, requirements in other laws that may prevent or inhibit the use of processes which delay the invocation of the law.<sup>97</sup>

### Contents of legislative provisions

#### *Commencement of expedited reorganization proceedings*

(146) The law should specify that expedited proceedings can be commenced on the application of any debtor that:

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<sup>97</sup> [from purpose clause (d)] For example, requirements for unanimous consent for adjustment of indebtedness outside of insolvency proceedings, liability for directors where the debtor continues to trade during the period when the out-of-court negotiations are being conducted, that do not recognize obligations for credit extended during such a period, and that restrict conversion of debt to equity.

[(a) is likely to be generally unable to pay its debts as they mature [or whose liabilities are likely to exceed its assets]] [is eligible to commence reorganization proceedings under the provisions of the insolvency law];

(b) has negotiated a plan and had it accepted by [the vote, solicited in accordance with applicable non-insolvency laws of a requisite majority of] each affected class of creditors and by each affected creditor not part of a voting class; and

(c) satisfies the jurisdictional requirements for commencement of full reorganization proceedings under the law.

#### *Application requirements*

(147) The law should specify that an application for commencement of an expedited reorganization proceeding should be accompanied by the following additional materials:

(a) the plan and disclosure statement;

(b) a description of the voluntary restructuring negotiations that preceded the making of the application for commencement, including the information provided to affected creditors to enable them to make an informed decision about the plan [or a summary of that information];

(c) certification that unaffected creditors are being paid in the ordinary course of business and that the plan does not modify or impair the rights or claims of preferential creditors, such as tax or social security authorities or employees without their agreement;

(d) a report of the votes of affected classes of creditors demonstrating that those classes have accepted the plan by the majorities specified in the law;

(e) a report of the acceptance of any individual creditors whose rights are modified by the plan;

(f) a financial analysis or other evidence which demonstrates that the plan satisfies all applicable requirements for reorganization; and

(g) a list of the members of any creditor committee formed during the course of the informal negotiations.

#### *Commencement*

(148) The law should specify that the application for commencement will automatically commence the proceedings or that the court will be required to promptly determine whether proceedings should commence.

#### *Effect of commencement*

(149) The law should specify that:

(a) provisions of the law that apply to full reorganization proceedings will also apply to expedited proceedings unless specified as not applicable;<sup>98</sup>

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<sup>98</sup> Provisions of the law that generally would not be applicable would include: full claim filing;



(b) [unless otherwise determined by the court] the effects of commencement should be limited to the debtor, individual creditors and classes of creditors and shareholders whose rights are modified or who are affected by the plan;

(c) any creditor committee formed during the course of the voluntary restructuring negotiations should be treated as a creditor committee appointed under the law; and

(d) a hearing on the confirmation of the plan should be held as expeditiously as possible.

*Notice of commencement*

(150) The law should specify that notice of the commencement of expedited proceedings be given to creditors and equity holders individually. The notice should specify:

(a) the amount of each affected creditor's claim according to the debtor;

(b) the time period for submitting a claim in a different amount if the affected creditor disagrees with the debtor's statement of the claim, and the place where the claim can be submitted;

(c) the time and procedure for challenging claims submitted by other parties;

(d) the time and place for the hearing on confirmation of the plan, and for the submission of any objection to confirmation; and

(e) the impact of the plan on shareholders.

*Confirmation of the plan*

(151) The law should specify that the court will confirm the plan if:

(a) the plan satisfies the substantive requirements for confirmation of a plan in full reorganization proceedings, in so far as those requirements apply to affected creditors and equity holders;

(b) the notice given and the information provided to affected creditors and equity holders during the voluntary restructuring negotiations was sufficient to enable them to make an informed decision about the plan [and any pre-commencement solicitation of acceptances to the plan complied with applicable law];

(c) unaffected creditors are being paid in the ordinary course of business and the plan does not modify or impair the rights or claims of priority creditors, such as tax or social security authorities or employees without their agreement;

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notice and time periods for plan approval; the post-commencement mechanics of providing the plan and disclosure statement to creditors and other interested parties and for solicitation of votes and voting on the plan; appointment of an insolvency representative (who generally would not be appointed unless required by the plan); provisions on amendment of the plan after confirmation. An exception to the provisions of the law applicable to full reorganization proceedings would be that creditors not affected by the plan would be paid in the ordinary course of business during the implementation of the plan.

(d) the financial analysis submitted with the application demonstrates that the plan satisfies all applicable requirements for reorganization .

*Effect of a confirmed plan*

(152) The law should specify that the effect of a confirmed plan should be limited to the debtor and those creditors and equity holders affected by the plan.

*Failure of implementation of a confirmed plan*

(153) The law should specify that where there is a substantial breach of the terms of the plan confirmed in accordance with recommendation (150), the proceedings may be [closed and creditors may exercise their rights at law] [converted to liquidation].

## **V. Management of proceedings**

### **A. Treatment of creditor claims**

#### **1. Introduction**

566. Claims by creditors operate at two levels in insolvency proceedings—firstly, for purposes of determining which creditors may vote in the proceedings and how they may vote (according to the class into which they fall and the value of their claim, where that is a relevant factor) and secondly, for purposes of distribution (see chapter V.B). The procedure for submission of claims and their admission is therefore a key part of the insolvency proceedings and consideration should be given to determining which creditors should be required to submit claims, the procedures applicable to the submission, verification and admission or denial of claims, the consequences of failure to submit a claim, and review of decisions concerning the admission or denial of claims. An insolvency law should also address the effect of submission and admission of claims, as this will be key to creditor participation. For example, submission of a claim may entitle a creditor to participate at the first meeting of creditors, while admission, or at least provisional admission, may be essential to enable a creditor to vote on various matters in the proceedings.

#### **2. Submission of creditor claims**

##### **(a) Creditors who may be required to submit claims**

567. The principal issue with regard to deciding which creditors will be required to submit a claim relates to the treatment of secured creditors, since unsecured creditors (irrespective of whether the debt is contingent or liquidated) are generally required to submit a claim (unless of course, the claims procedure provides an alternative mechanism for verification and admission of claims that does not require all creditors to submit claims—discussed below).

568. Under those insolvency laws which do not include encumbered assets in the insolvency estate and allow secured creditors to freely enforce their secured interest against the encumbered assets, secured creditors may be excluded from the requirements to submit a claim to the extent that their claim will be met from the value of the sale of the encumbered asset. To the extent that the value of the

encumbered asset is less than the amount of the secured creditor's claim, the creditor may be required to submit a claim for the unsecured portion as an ordinary unsecured creditor. The value of the unsecured claim thus depends upon the value of the encumbered asset and the time at which that value is determined and the method of valuation used. Unless clear rules apply to valuation, there is the potential for some uncertainty, particularly in terms of deciding voting rights where they are calculated by reference to the value of claims.<sup>99</sup>

569. Another approach requires secured creditors to submit a claim for the total value of their security interest irrespective of whether any part of the claim is undersecured, a requirement which in some laws is limited to the holders of certain types of security interest, such as floating charges, bills of sale, or security over chattels. Some of those jurisdictions requiring all secured creditors to submit a claim include serious consequences for those failing to do so (discussed below). Some insolvency laws also permit secured creditors to surrender their security interest to the insolvency representative and to submit a claim for the total value of the security interest.

570. Where secured creditors are required to submit a claim, the procedures for submission and verification are generally the same as for unsecured creditors. The rationale of requiring secured creditors to submit claims is that it will provide information to the insolvency representative as to existence of all claims, the extent of the secured debt and the assets that might be subject to a security interest, as well as the total amount of the outstanding debt. Whichever approach is chosen, it is desirable that an insolvency law includes clear rules on the treatment of secured creditors for the purposes of submission of claims. It is also important, particularly where an insolvency law provides that the claims procedure can affect the security rights of a secured creditor, that notification of the commencement of proceedings include information regarding the submission, or failure to submit, secured claims.

**(b) Limitations on claims that can be submitted**

571. It has not been unusual in the past for insolvency laws to limit the types of claims that could be submitted, excluding, for example, unliquidated tort claims. More recently, however, there has been a trend towards widening the definition of claims that can be submitted to include those unliquidated tort and contract claims, as well as contingent claims. If such claims are not included in the insolvency proceedings, the creditors holding those claims cannot participate and have no recourse for collecting their debt from the debtor. It is therefore desirable for an insolvency law to adopt a broad definition of claims that can be submitted. It should be noted, however, that expanding that definition has the potential to make the insolvency proceedings more complicated, particularly when those claims have to be valued to enable submission and admission, even on a provisional basis.

*(i) Post-commencement debt*

572. As a general principle, claims can only be submitted in respect of debt incurred prior to commencement. How debt incurred after commencement is treated will depend on the nature of the proceedings and the provisions of the insolvency

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<sup>99</sup> On the valuation of encumbered assets, see chapter II.B.8.

law—many laws provide that such debts are payable in full as costs of the proceedings (see chapter V.B).

(ii) *Types of excluded claims*

573. For a variety of public policy reasons, an insolvency law may seek to exclude certain types of claims from the insolvency proceedings. Examples include foreign tax claims, fines and penalties, claims relating to personal injury, claims relating to negligence, and gambling debts. Some insolvency laws provide that those claims can be submitted, but that they may be subject to special treatment, such as subordination to other unsecured claims. It is highly desirable that an insolvency law identifies those claims that are to be excluded from the insolvency process (or subjected to special treatment –see chapter V.B).

- *Foreign tax claims*

574. Foreign tax claims are currently excluded by many countries, and it is generally recognized that such an exclusion does not violate the objective of equal treatment of foreign and domestic creditors. Despite this general view, however, there are no compelling reasons why such claims cannot be admitted if a country wishes to do so. Where foreign tax claims are admitted, they can be treated in the same manner as domestic tax claims or as ordinary unsecured claims. Article 13(2) of the UNCITRAL Model Law on Cross-Border Insolvency recognizes these different approaches, providing that the principle of equal treatment of foreign and domestic creditors is not affected by the exclusion of foreign tax and social security claims or by their ranking on the same level as general non-preference claims or lower if equivalent local claims have that lower ranking.

- *Claims arising from illegal activity*

575. Where gambling debts are treated as excluded claims it is generally on the basis that they arise from an activity that is itself illegal. Rather than focussing upon specific examples of claims that may be excluded as illegal, an insolvency law may exclude, as a general category, those claims that arise from illegal activity and are unenforceable.

- *Fines and penalties*

576. With respect to fines and penalties, an insolvency law may distinguish between those which are of a strictly administrative or punitive nature (such as a fine imposed as the result of an administrative or criminal violation) and those of a compensatory nature. It may be argued that the first category of fines and penalties should be excluded on the basis that they arise from some wrongdoing on the part of the debtor and unsecured creditors should not be made to bear the burden of that wrongdoing by seeing a reduction in the assets available for distribution. In comparison, there would seem to be no compelling reason for excluding the second category, particularly where it relates to recompense for damage suffered by another party, except to the extent that exclusion may also be justified as a means of increasing the assets available to unsecured creditors. An alternative approach would be to admit claims based on fines and penalties because otherwise they will remain uncollected.

(c) **Procedure for submission of claims**

(i) *Timing of submission of claims*

577. To ensure that claims are submitted in a timely fashion and that the insolvency proceedings are not unnecessarily prolonged, deadlines for submission of claims can be specified. Some insolvency laws specify that claims are to be submitted within a certain period after commencement of proceedings or by reference to some other specified event in the proceedings. Other laws provide for determination of the deadline by the court or insolvency representative and require that deadline to be within a range specified in the insolvency law, with examples ranging from 10 days to three months after a specified event, such as commencement. Other insolvency laws do not establish any deadlines for submission, and leave it up to the insolvency representative to determine the timing of submission of claims, or provide for claims to be submitted at any time up until some specified point in the proceedings, such as the final report and accounting by the insolvency representative. Some insolvency laws also establish different time limits depending upon the method of notification of commencement; where the creditor is a known creditor and receives personal notification of the commencement of proceedings the time limit may be shorter than where the creditor has to rely on public notification of commencement. A key factor in determining any deadline for submission will be the procedure for verification and admission of claims. If that process is required to take place at a court hearing or a meeting of creditors convened for that purpose, there is likely to be less flexibility with respect to the timing of the submission of claims, and claims not submitted by the specified date before that meeting or hearing will require a special hearing or meeting to be convened. Where verification and admission is conducted by the insolvency representative, greater flexibility will be possible since there will not be the same need to satisfy procedural requirements associated with convening meetings of creditors or court hearings.

578. While deadlines may assist in ensuring that the claims process does not impose unnecessary delay on the proceedings, they may operate to disadvantage foreign creditors who in many cases may not be able to meet the same deadlines as domestic creditors. To ensure the equal treatment of domestic and foreign creditors, and to take account of the international trend of abolishing discrimination based upon the nationality of the creditor, it may be possible to adopt an approach that either allows claims to be submitted at any time prior to distribution or some other specified event, or sets a time limit which can be extended or waived where a creditor has good reason for not complying with the deadline, or where the deadline operates as a serious impediment to a creditor.

579. Where a deadline is established (whether by the insolvency law, the court or insolvency representative) and the claim is submitted late causing costs to be incurred, those costs could be borne by the creditor. Where claims can be submitted at an advanced stage of the proceedings, an associated question to be addressed is whether interim distributions can be made before all claims have been submitted and, if so, whether creditors submitting their claims after a distribution has been made nevertheless can participate in that distribution. Some insolvency laws provide that such a creditor can only participate in distributions occurring after submission, while others require the insolvency representative to make provision for creditors that have not submitted their claims at the time of the distribution.

(ii) *Burden of submitting and proving claims*

580. Many insolvency laws place the burden of submitting and proving a claim upon creditors. Generally they will be required to produce evidence, in some cases by way of a standard claim form accompanied by supporting documentation, as to the amount of the claim, the basis of the debt and any preferences or security claimed. . Many laws provide that the insolvency representative is entitled to request the creditor to provide additional information or documentation to prove their claim; some laws also permit claims that have not been properly proved to be rejected. Admission may be assisted in some jurisdictions by requiring claims to be submitted in the form of a declaration, such as an affidavit, to which sanctions would attach in the event of fraud; the formalities associated with such declarations in some jurisdictions has led to that practice being abandoned.

581. A number of insolvency laws permit claims to be admitted without the creditor having to submit and prove a claim in circumstances such as where the insolvency representative is able to ascertain, from the debtor's books and records, which creditors are entitled to payment and the amount of the debt. Although in many insolvency cases the books and records of the debtor may not be completely reliable, this method of admission has the advantage of reducing formalities associated with verification and admission of claims and may be appropriate where the claims are not disputed (discussed further below). This approach may be facilitated by requiring, as an initial step in the proceedings, preparation of a list of creditors and claims.. Preparation of such a list by the debtor takes advantage of the debtor's knowledge about its creditors and their claims and can give the insolvency representative an early indication of the state of the business. An alternative approach could require the insolvency representative to assist the debtor to prepare that list or the insolvency representative to prepare the list. While the latter approach may serve to reduce the formalities associated with the process of verification of claims, it may add to costs and delay, since it relies upon the insolvency representative being able to obtain accurate and relevant information from the debtor. Once the list is prepared, it could be used to assess which creditors claims could be admitted without formal proof and which creditors should be invited to make their claims to the insolvency representative for purposes of verification, as well as for the purposes of ensuring that all relevant creditors have submitted claims. The list could also be revised and updated over time to provide not only an accurate indication of the level of the debtor's indebtedness, but also the status of verification and admission of claims.

582. It is desirable that an insolvency law addresses the question of false claims and provide appropriate sanctions for creditors and others who lodge claims that prove to be false.

(iii) *Formalities for submission of foreign claims*

583. An issue of particular importance to foreign creditors is whether the claim must be submitted in the language of the jurisdiction in which the insolvency proceedings have commenced, and whether the claim is subject to certain formalities, such as notarization. To facilitate the access of foreign creditors, it is desirable that consideration is given to whether these requirements are essential or may be relaxed as in the case of other procedural formalities discussed in respect of

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article 14 of the UNCITRAL Model Law on Cross-Border Insolvency (see chapter VII).

(iv) *Conversion of foreign currency claims*

584. Where the debtor has business activities in different countries, creditors may have debt denominated in currencies other than that of the country of the insolvency proceedings. For verification and distribution purposes, these claims are normally converted into the domestic currency, although circumstances may exist in which conversion is not required. The date of conversion may have been agreed in the contract between the debtor and creditor, or it may be set by the insolvency law by reference to a fixed time, such as commencement or other point of the proceedings. Where there is a time difference between the date of conversion and the date of distribution (which could occur at a significantly later time), there is the potential for the currency to depreciate or appreciate in that period and thus for the amount of the claim also to fluctuate. Where the currency is relatively stable, this fluctuation may not be significant. In times of severe currency instability, however, the fluctuation could result in a creditor being significantly disadvantaged in favour of other creditors or advantaged at the expense of other creditors. In such circumstances, an insolvency law might provide that a provisional conversion is made at the time of commencement for the purposes of voting, and where the exchange rate fluctuates more than a given percentage (which is stipulated in the insolvency law) in the period before distribution, the conversion will be made at the time of distribution or an appropriate adjustment can be made to the earlier calculation.

(v) *Party authorized to receive claims*

585. Insolvency laws generally adopt one of two approaches to the question of to whom claims should be submitted. Some laws require the claim to be submitted to the court, while others provide for claims to be submitted to the insolvency representative, where the basis for the difference generally relates to the process of verification and the respective roles of the court and the insolvency representative. Where the insolvency representative is responsible for verification and admission of claims, creditors would generally have a right of recourse to the court to dispute issues relating to the value or priority accorded to the admitted claim or to the denial of the claim (see below).

**(d) Failure to submit claims**

(i) *Failure to submit within a stipulated time period*

586. Insolvency laws adopt different approaches to those claims not submitted within any specified time limit. Some laws adopt a flexible approach providing that notwithstanding the application of a deadline, claims still can be submitted at any time up to, for example, the insolvency representative's final report and accounting in liquidation, but the creditor must bear any additional costs associated with late submission. One consequence of late submission may be that the creditor cannot participate in interim distributions occurring before submission (or admission) of the claim, although as noted above there are examples of laws which permit the creditor to receive previous interim dividends once the claim has been admitted. A

further consequence is the loss of the right to vote at meetings of creditors, where submission of a claim is a pre-requisite to that participation.

587. Another approach to submission of claims adheres strictly to submission deadlines, and some laws provide that failure to submit a claim may result in the debt being extinguished or security rights being waived or forfeited, provided the creditor received the prescribed notification of commencement and the need to submit a claim. Other laws require the creditor who has failed to submit its claim by the deadline to petition the court for admission. Where the court admits the claim, the creditor may be limited to sharing only in future dividends.

588. While creditors should be given the widest possible opportunity to submit their claim in insolvency proceedings and must therefore receive timely and appropriate notice of commencement and of the need to submit a claim, the proceedings should not be delayed by creditors who are aware of the need to submit and of the applicable deadlines, but nevertheless fail to do so in a timely manner since this has the potential to increase the costs of the proceedings and disadvantages other creditors. The consequences of failure to submit should therefore be clearly defined and creditors should be made aware of them at the time they are notified of the deadlines for submission.

(ii) *Failure to submit a claim before conclusion of the proceedings*

589. The failure of a creditor to submit a claim before the final report and accounting may lead to different results depending upon other provisions of the insolvency law. Some of those insolvency laws that provide for a discharge of the debtor upon conclusion of the insolvency proceedings also provide that claims not submitted in the insolvency proceedings are forfeited.

**3. Verification and admission of claims**

**(a) List of submitted claims**

590. Many insolvency laws require the court or the insolvency representative, depending upon requirements for submission, to prepare a list of submitted claims, either after expiry of the deadline for submission of claims or on a continuing basis in cases where there is no deadline or the deadline occurs later in the proceedings. Where the insolvency law requires preparation of a list of creditors as discussed above (see also chapter III.A), the list of claims would update that earlier list of creditors and be used as the basis of verification and admission of claims and for notification as to the receipt, admission or denial of claims, depending upon the applicable admission procedure. Many insolvency laws provide that all identified and identifiable creditors are entitled to receive notice of claims that have been made, whether personally, by publication of notices in appropriate commercial publications or by filing a list with the court. This will enable creditors, the debtor and interested parties to see what claims have been submitted and to object to the claims listed (where this is permitted under the insolvency law).

**(b) Procedures for verification and admission**

591. Verification involves not only an assessment of the underlying legitimacy and amount of the claim, but also classification of a claim for purposes of voting and distribution (e.g. secured or unsecured claims; priority claims and so on).



(i) *Deadline for verification and admission*

592. A number of insolvency laws impose time limits for verification and admission of claims, requiring that a decision be provided to creditors within a short period, for example 30 days after the expiry of the deadline for submission. Other laws make no provision for time limits. A key factor in deciding whether or not an insolvency law should impose time limits in this case is the procedure for verification and admission requires a court hearing or a meeting of creditors to be held or is conducted by the insolvency representative. In the case of the former, admission usually occurs at the hearing or meeting of creditors, subject to resolution of disputes arising from challenges to claims. For reasons of transparency and certainty, and to ensure the efficient conduct of the proceedings without undue delay, it is desirable that the decision on admission or non-admission be made in a timely manner, particularly where admission will determine participation in the proceedings and voting rights. However, as is generally the case with any consideration of the need for a time limit, the advantages of establishing a limit must be weighed against the potential disadvantages of inflexibility and the need to ensure the time limit is properly observed.

(ii) *Admission procedure*

593. Insolvency laws adopt a variety of approaches to the admission procedure, involving differing degrees of complexity and levels of involvement by the court, the insolvency representative and creditors, in some cases requiring input from all of these at various times. When coupled with rights of appeal and the difficulties associated with processing those types of claims requiring valuation, the complexity of the process has the potential to significantly interrupt the conduct of the proceedings and cause delay that will affect other steps in the proceedings. For these reasons, it is highly desirable that formalities are minimised and that decision-making is as streamlined as possible.

*- Admission by the insolvency representative*

594. As noted above, insolvency laws generally require claims to be submitted to the insolvency representative or to the court. Many insolvency laws provide that where the claim is to be submitted to the insolvency representative, it is for the insolvency representative to verify the claims and decide whether or not they should be admitted, whether in whole or in part. The creditor will be notified of the insolvency representative's decision and where the claim is denied, or admitted only in part, the insolvency representative is generally required to provide reasons for that decision (often required to be given in writing). A requirement to provide written reasons will enhance the transparency of the procedure, as well as, potentially, its predictability for creditors. Some insolvency laws also require, as already noted, the insolvency representative's decisions on admission of claims to be regularly updated on the list of claims that is filed with the court or made public in some other way in order to facilitate consideration by other creditors and the debtor. Where, following appropriate notification, the insolvency representative does not receive any objections to claims that it proposes to admit, a number of insolvency laws provide that the claim is then deemed to be admitted.

595. Under other insolvency laws the insolvency representative is required to convene a meeting of creditors to consider submitted claims on the basis of the list

it has prepared and provided to creditors. That list may be required to include recommendations as to admission, value and priority of individual claims. Where no objections to admission of claims are made at that meeting, the insolvency laws adopting this approach typically provide that the insolvency representative's recommendations are deemed under the insolvency law to be approved or the claims are deemed to be admitted.

*- Admission by the court*

596. Where claims are to be submitted to the court, the court generally will convene the meeting or hearing at which claims are examined and a decision made as to admission. A number of laws require claims to be submitted within a certain number of days before the date fixed for the meeting and the preparation of a provisional list of admissions, either by the court or by the insolvency representative to be provided to all creditors before the hearing or meeting. Where no objections to admission of the listed claims are made at that meeting, the claims are typically deemed under the insolvency law to be admitted.

*- Requirements for personal appearance of creditors*

597. One issue that may be of concern to creditors, and particularly to foreign creditors, is the requirement in some insolvency laws for them to personally attend creditor meetings called for the purpose of considering claims in order for their claims to be admitted. Such a requirement has the potential to frustrate the goal of equal treatment of similarly situated creditors and cause delay. It is therefore desirable that an insolvency law not require that in all cases creditors must appear in person for their claim to be admitted, but rather that they can be admitted on the basis of documentary evidence.

(iii) *Automatic admission of claims*

598. With a view to minimising the formalities required for verification and admission of claims, an alternative approach to those outlined above may be to provide that claims outstanding at the time of commencement do not require verification and can be admitted on an automatic basis unless the claim is challenged. This approach will require some mechanism for determining the existence, value and priority of claims. While it may not be sufficient in all cases for reasons of reliability and completeness, it may be appropriate to rely, in the first instance, upon the books and records of the debtor and the list of creditors to be prepared in the proceedings to identify all outstanding claims. Where those claims are not disputed, the claim might be admitted without the creditor having to formally submit and prove its claim. Automatic admission of claims in this manner may avoid many of the difficulties associated with the need for a precise assessment of the situation at the outset of the proceedings to enable creditors to participate in and vote at meetings held at an early stage of the proceedings.

(iv) *Provisional admission of claims*

599. Creditor claims may be of two types: liquidated claims and unliquidated claims where the amount owed by the debtor has not been determined at the time the claim is to be submitted or cannot presently be determined (for example, because it is the subject of a court action that has not been finalised at the time of

commencement and may be subject to the stay). Such claims may be either contractual or non-contractual in nature and may arise in respect of both secured and unsecured claims. Claims may also be conditional, contingent and not mature at the time of commencement (the latter would generally be subject to a deduction for the unexpired period of time before maturity).

600. Where the amount of the claim cannot be or has not been determined at the time the claim is to be submitted, many insolvency laws provide for a claim to be admitted provisionally, subject to giving it a notional value. Determining a value for such claims raises a number of issues such as the time at which the value is to be determined and whether it must be liquidated (in which case it will need to be considered by a court), or estimated (which might be undertaken by the insolvency representative, the court or some other appointed person). Where a court is required to determine the issue, an associated question relates to the court that will be appropriate (the insolvency court or some other court) and how any delay in reaching a determination can be addressed in terms of its effect on the conduct of the insolvency proceedings. The question of valuation of unliquidated claims can have a significant impact on insolvency proceedings where, for example, mass tort claims are involved. As to timing of the valuation, many insolvency laws require it to refer to the commencement of proceedings, although special rules may be required where proceedings are converted from one form of proceeding to another.

601. An important reason for permitting provisional admission is to allow creditors holding those claims to participate in the proceedings, and in particular to vote on key issues, such as on approval of the reorganization plan or on other key issues requiring a decision by creditors.

602. Where an insolvency law provides for provisional admission of claims, it may be necessary to consider whether such claims will be subject, in the first instance, to the same procedure as other claims. For example, where admission involves a hearing before the court or a meeting of creditors to be called, claims that might be provisionally admitted could be subject to that procedure, or they could first be admitted by the insolvency representative, without prejudice to the right of a dissenting party to dispute that claim, and be subject to some procedure for approval at a later stage. Other issues requiring consideration include whether, when creditors with provisionally admitted claims do vote on a reorganization plan, they can as minority creditors, be bound by a plan to which they have not agreed (see chapter IV); whether creditors with provisionally admitted claims are entitled to participate in distributions occurring before the claim has been fully admitted; and, if a provisionally admitted claim is subsequently denied or admitted only in part, the effect of non-admission on decisions in which that creditor has participated. Provisional admission of a claim will generally entitle the creditor to participate in the proceedings to the same extent as other creditors, except that they may not be entitled to participate in distributions until the value of the claim is finally fixed and the claim admitted. Where, however, the claim is not ultimately fully admitted, any previous votes by the creditor in the proceedings may be discounted.

**(c) Disputed claims**

603. Where an insolvency law allows a claim submitted in the insolvency proceedings to be disputed, whether as to its value, priority, or basis, it is desirable that it also specifies the parties that are entitled to initiate such a challenge. Some laws allow claims

to be disputed only by the insolvency representative, while other laws permit other interested parties, including other creditors and the debtor, to dispute a claim. Depending upon the procedures for submission and admission of claims, the dispute may be raised with the insolvency representative, or before or at the court hearing or creditors meeting held to examine claims. Where such a meeting or hearing is held, the preparation of a provisional list of admissions, either by the court or by the insolvency representative and the provision of that list to all creditors before the hearing or meeting will facilitate the consideration of claims. Where claims are disputed in the insolvency proceedings, whether by a creditor, the insolvency representative or the debtor, a mechanism for quick resolution of the dispute is essential to ensure efficient and orderly progress of the proceedings. If disputed claims cannot be quickly and efficiently resolved, the ability to dispute a claim may be used to frustrate the proceedings and create unnecessary delay. Most insolvency laws provide for disputes to be resolved by the court to ensure finality of the decision.

604 Where claims submitted in the proceedings are the subject of a dispute outside of the insolvency proceedings, they may generally fall into one or other of the categories of claims that may be provisionally admitted in the insolvency proceedings, depending upon the nature of the claim, and pending resolution of that dispute (subject to application of the stay—see chapter II.B.3(a) and 8).

**(d) Effect of admission of a claim**

605. Admission of a creditor's claim will establish the right of that creditor to attend meetings of creditors, and the amount for which the creditor is entitled to vote at such meetings, whether on the election of an insolvency representative or approval of a reorganization plan or some other matter specified in the insolvency law. It will also fix the amount and priority of the claim that the insolvency representative must take into account in making a distribution to creditors.

**(e) Set-off of mutual claims**

606. As noted above in chapter II.G, a number of insolvency laws make provision for mutual money obligations between the debtor and creditors to be set-off in insolvency proceedings, provided certain conditions are met. These may include, for example, requirements that the claims existed and were due and payable at the time of commencement of the proceedings; that the creditor acquired the claim without fraud or was not aware of the financial situation of its debtor; that the creditor did not acquire the claim during the suspect period; that the creditor has declared its intention to seek a set-off to the insolvency representative; and that the claims were related. A very few insolvency laws provide for mandatory set-off in insolvency, while a number of other laws do not permit set-off on the basis that it violates the *pari passu* principle. Where set-off is permitted, it will usually be taken into account by the insolvency representative or the court when verifying and admitting claims.

**(f) Claims requiring special treatment**

*(i) Administrative claims*

607. Insolvency proceedings often require the assistance of professionals, such as the insolvency representative and advisors to the debtor or insolvency representative. Expenses may be incurred by creditor committees, for the purposes of operating the

business of the debtor, including many or all post-commencement debts, such as claims of employees, lease costs and similar claims, and in otherwise carrying out the proceedings.

608. Notwithstanding the importance of providing appropriate remuneration to those involved in the conduct of the insolvency proceedings, administrative expenses have the potential for a significant impact on the value of the insolvency estate. While to some extent that impact will depend upon the design of an insolvency law and its supporting infrastructure, consideration of how that impact can be minimised may be desirable. An insolvency law can provide, for example, precise but flexible criteria relating to the allowance of those expenses. These criteria may include allowing expenses on the basis of the utility of the expense to increasing the value of the estate for the general benefit of all constituents, or on the basis that they are not only reasonable and necessary, but also consistent with the key objectives of the process. Reasonableness of the expense may be assessed by reference to the amount of resources available to the proceedings and to the possible effect of the expense on the proceedings.

609. Different approaches may be taken to conducting that assessment. One approach may be to require authorization by the court prior to the cost being incurred, or authorization by the court of all costs falling outside the scope of the ordinary course of business. Another approach may be to require creditors to make the assessment, to facilitate the transparency of the proceedings, subject to recourse to the court in the event that the assessment of the creditors is disputed.

(ii) *Claims by related persons*

610. A category of creditors that may require special consideration is those persons related to the debtor, whether in a familial or business capacity (discussed above, see chapter II.F.3(e)). Special treatment of the claims of these persons is often justified on the basis that they are more likely than other creditors to have been favoured and to have had early knowledge of the financial difficulties of the debtor. While they do not properly fall within classes of excluded claims, it may be appropriate to consider whether they should be admitted and treated in the same way as other creditors or be admitted subject to special treatment. The mere fact of a special relationship with the debtor, however, may not be sufficient in all cases to justify special treatment of a creditor's claim. In some cases these claims will be entirely transparent and should be treated in the same manner as similar claims made by creditors who are not related persons; in other cases they may give rise to suspicion and will deserve special attention. An insolvency law may need to include a mechanism to identify those types of conduct or situations in which claims will deserve additional attention, such as where the debtor is severely undercapitalized (e.g. where the principal of the debtor has advanced funds to the company in the form of a loan when the company is undercapitalized and continues to trade without sufficient funds to pay creditors) or where there is evidence of self-dealing (i.e. that the related persons have taken advantage of their position to obtain a benefit e.g. where 6 months before liquidation the principal agrees to a compensation package which the company cannot pay, and files a claim for it in the liquidation). In those cases, the claim may be restricted in the amount that can be admitted or subordinated to the claims of other classes of creditors (see chapter V.B), or the voting rights of the related creditor can be restricted with respect to certain issues

(such as in selection of the insolvency representative, where the insolvency law allows creditors that choice).

(iii) *Claims for interest*

611. Different approaches are taken to the accrual and payment of interest on claims. Some insolvency laws provide that interest on claims ceases to accrue on all unsecured debts once liquidation proceedings have commenced, but that payment in reorganization will depend upon what is agreed in the plan. Other insolvency laws provide that interest may accrue, but payment will be given a low priority, such as after the payment of all unsecured creditors.

**4. Claims not admitted**

612. Many insolvency laws provide that where a claim is denied, the creditor concerned will have a right to seek review of the decision not to admit, whether that decision was made by the court or the insolvency representative, within a specified period of time. Examples include periods from 10 to 45 days (see chapter II.D).

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on creditor claims is to:

- (a) define the claims that can or are required to be submitted and the treatment to be accorded to those claims;
- (b) enable persons who have a claim against a debtor to submit claims against the estate;
- (c) establish a mechanism for verification and admission of claims;
- (d) provide for review of disputed claims;
- (e) ensure that similarly ranked creditors are treated equally.

### **Contents of legislative provisions**

#### *Requirement to submit*

(154) The law should require creditors to submit their claims,<sup>100</sup> including the basis and amount of the claim. The law should also minimize the formalities associated with submission of claims.

#### *Claims that may be submitted*

(155) The law should specify that claims that may be submitted include all rights to payment which arise from acts or omissions of the debtor<sup>101</sup> prior to

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<sup>100</sup> The insolvency law should address claims that may require special treatment, for example claims of foreign creditors, conditional or non-conditional monetary claims, claims for interest, and claims in respect of unmature liabilities.

<sup>101</sup> This would include claims by third parties or a guarantor for payment arising from acts or omission of the debtor.

commencement of the insolvency proceedings, whether mature or not, whether liquidated or unliquidated, whether fixed or contingent.<sup>102</sup> The law should identify claims that will not be affected by the insolvency proceedings.<sup>103</sup>

#### *Secured claims*

(156) The law should specify whether secured creditors are required to submit claims.<sup>104</sup>

#### *Equal treatment of similarly ranked creditors*

(157) The law should specify that all similarly ranked creditors, regardless of whether they are domestic or foreign creditors, are to be treated equally with respect to the submission and processing of their claims.

#### *Timing of submission of claims*

(158) The law should specify the time period after commencement in which claims may be submitted, which time period should be adequate to allow creditors to submit their claims.

#### *Consequences of failure to submit a claim*

(159) The law should specify the consequences of failure to submit a claim within the time limit.

#### *Foreign currency claims*

(160) Where claims are denoted in foreign currency, the law should specify the circumstances in which those claims must be converted and the reasons for conversion. Where conversion is required, the law should specify that the claim will be converted into local currency by reference to a specified date, such as the date of commencement of insolvency proceedings, [subject to special measures that may apply in situations of high currency instability].

#### *Evidence of claims*

(161) The law may permit claims that are undisputed to be admitted by reference to the list of creditors and claims prepared by the debtor in cooperation with the insolvency representative<sup>105</sup> or the court or the insolvency representative may require a creditor to give to provide evidence of its claim. , The law should not require that in all cases a creditor must appear in person to prove its claim.

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<sup>102</sup> See chapter II.E for recommendations in respect of claims arising from rejection of contracts.

<sup>103</sup> Some insolvency laws provide, for example, that claims such as [government] fines and penalties and taxes will not be affected by the insolvency proceedings. Where a claim was to be unaffected by the insolvency proceedings it would continue to exist and would not be included in any discharge.

<sup>104</sup> See UNCITRAL Model Law on Cross-Border Insolvency, art. 14 (3) and para. 111 of the Guide to Enactment, which notes that under some laws a secured creditor who files a claim is deemed to have waived the security or some of the privileges attached to the credit, while under other laws failure to submit a claim has that result.

<sup>105</sup> See recommendations on duties and functions of the debtor and insolvency representative.

*Admission or denial of claims*

(162) The law should permit the insolvency representative to admit or deny any claim, in full or in part.<sup>106</sup> Where the claim is to be denied, whether in full or in part, notice of the reasons for the decision to deny should be given to the creditor.

(163) The law should permit creditors whose claims have been denied, whether in full or in part, to request [within a specified period of time after notification of the decision to deny the claim], the court to review their claim.

*Disputing a claim*

(164) The law should permit an interested party to dispute any submitted claim, either before or after admission, and request review of that claim by the court.

*Provisional admission*

(165) The law should specify that, claims disputed in the insolvency proceedings can be admitted provisionally by the insolvency representative pending resolution of the dispute by the court.

[(166) The law should permit unliquidated claims to be admitted provisionally, pending determination of the amount of the claim by the insolvency representative.]

[(167) The law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion unsecured by valuing the encumbered asset.]

*Effects of admission*

(168) The law should specify the effects of admission, including provisional admission, of a claim. These effects may include:

- (a) Entitling the creditor to participate in the proceedings and to be heard;
- (b) Permitting the creditor to vote at a meeting of creditors, including on approval of a plan;
- (c) Determining the priority to which the creditor's claim is entitled;
- (d) Determining the amount for which the creditor is entitled to vote;
- (e) Except in the case of provisional admission of a claim, permitting the creditor to participate in a distribution.<sup>107</sup>

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<sup>106</sup> In some jurisdictions, the court may be required to ratify the decision of the insolvency representative.

<sup>107</sup> However, when making a distribution, the insolvency representative may be required to take account of claims which have been provisionally admitted, or submitted but not yet admitted: see chapter V.B



*Claims by related parties*

(169) The law should specify that claims by related parties should be subject to scrutiny and, where justified:<sup>108</sup>

- (a) The voting rights of the related party may be restricted;
- (b) The amount of the claim of the related party may be restricted; or
- (c) The claim may be subordinated.<sup>109</sup>

**B. Priorities and distribution [of proceeds of liquidation]****1. Priorities****(a) Introduction**

613. There are many diverse and competing interests in an insolvency proceeding. For the most part, creditors are creditors by virtue of having entered into a legal and contractual relationship with the debtor prior to the insolvency. There are creditors, however, who have not entered into such an arrangement with the debtor, such as taxing authorities (who will often be involved in insolvency proceedings) and tort claimants (whose participation will generally be less common). Accordingly, the rights of creditors will be governed by a number of different laws.

614. While many creditors may be similarly situated with respect to the kinds of claims they hold based on similar legal or contractual rights, others may have superior claims or hold superior rights. For these reasons, insolvency laws generally rank creditors for the purposes of distribution of the proceeds of the estate in liquidation by reference to their claims, an approach not inconsistent with the objective of equitable treatment. To the extent that different creditors have struck different commercial bargains with the debtor, the ranking of creditors may be justified by the desirability of the insolvency system recognizing and respecting the different bargains, preserving legitimate commercial expectations, fostering predictability in commercial relationships and promoting the equal treatment of similarly situated creditors. Establishing a clear and predictable ranking system for distribution can help to ensure that creditors are certain of their rights at the time of entering into commercial arrangements with the debtor and, in the case of secured credit, facilitate its provision.

615. There is, however, a limit on the extent to which these goals can be achieved, given the balance that is desirable in an insolvency law between these competing objectives and other public policy considerations. To the extent that these broader public interests compete with private interests, they may lead to a distortion of normal commercial incentives. In addition to relying upon rankings based upon commercial and legal relationships between the debtor and its creditors, distribution policies also very often reflect choices that recognize important public interests (such as the protection of employment), the desirability of ensuring the orderly and effective conduct of the insolvency proceedings (providing priority for the remuneration of insolvency professionals and the expenses of the insolvency

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<sup>108</sup> Sufficient justification may involve situations where the debtor is undercapitalized or there has been self-dealing, as noted above, see 3 (f) (ii).

<sup>109</sup> On subordination, see chapter V.B

administration), and promoting the continuation of the business and its reorganization (by providing a priority for post-commencement finance). Where public interests are given priority, and equality of treatment based upon the ranking of claims is not observed, it is desirable that the policy reasons for establishing that priority be clearly stated in the insolvency law. In the absence of equality of treatment, this approach will at least provide an element of transparency and predictability in the area of claims (see chapter V.A), distribution (see chapter V.C) and the establishment of creditor classes under a reorganization plan (chapter IV.A).

616. Insolvency laws adopt a wide variety of different approaches to the ranking of creditors, both in terms of priorities between different ranks and in terms of the treatment of creditors within a particular rank, for example those creditors broadly defined as unsecured, where different sub-ranks may be employed.

**(b) Subordination of claims**

617. When an individual or organization owes debts to more than one creditor, the priority scheme established in the applicable law or by agreement between the parties will determine the order in which those debts should be paid. Even where a priority scheme is in place, however, a creditor with a higher priority may be paid after one with a lower priority because of subordination.

618. Subordination refers to a rearranging of the creditors' priorities and does not relate to the validity or legality of a claim. A subordinated claim may be valid and enforceable but because of an agreement or a court decision, it will be paid later in the distribution scheme than it would otherwise be paid. These two types of subordination are discussed below.

*(i) Contractual subordination*

619. Contractual subordination occurs when two or more creditors of a single debtor enter into an agreement (referred to as "subordination" or "distribution agreements") which provides that one creditor agrees to receive payment on its claim against the debtor after the payment of another creditor. These agreements may be between secured creditors or between unsecured creditors. If between secured creditors, the agreement usually provides that one creditor receives priority over the holder of an otherwise senior security interest. Agreements between unsecured creditors typically provide that one creditor will receive payment in full on its claim before the subordinated creditor receives any distribution.

620. Subordination agreements can arise in different contexts. For example, debenture holders typically agree to subordinate their claims to the debtor's working capital lender. Also, when a business is in financial distress, certain creditors may agree to subordinate their claims in order to aid the business's reorganization efforts. Some creditors may agree to subordinate themselves to a lender injecting new money into the business in the hope that the new money will help the business recover and, thus, improve the prospects of the subordinated creditors being paid in full.

621. The laws that determine contract validity and enforceability also apply to subordination agreements, as do the normal contract defences such as lack of consideration, fraud, and unconscionability.

(ii) *Subordination by the court (referred to as equitable subordination)*

622. This type of subordination occurs where a court has the power to change the priority of payment of claims to prevent, for example, a claimant who has committed fraud or some other illegal activity or acted inappropriately to gain an advantage over other creditors, from benefiting from that act. The doctrine originally arose to prevent related persons from using legal mechanisms to obtain advantages in priority.

623. For this type of subordination to apply, the conduct under consideration must actually result in some harm to other creditors such as altering the normal distribution scheme and giving a creditor an unfair priority position. The court could then use subordination to restore the priority scheme so that a fair distribution occurs. If the conduct occurs but does not result in an unfair advantage, subordination generally cannot be used.

(c) **Ranking of claims**

(i) *Secured creditors*

624. Many insolvency laws recognize the rights of secured creditors to have a first priority for satisfaction of their claims, either from the proceeds of sale of the specific assets secured or from general funds. The method of distribution to secured creditors depends on the method used to protect the secured creditor during the proceedings. If the security interest was protected by preserving the value of the encumbered asset, the secured creditor generally will have a priority claim on the proceeds of the sale of that asset to the extent of the value of its secured claim. Alternatively, if the security interest was protected by fixing the value of the secured portion of the claim at the time of the commencement of the proceedings, the creditor generally will have a priority claim to the general proceeds of the estate with respect to that value. Where the secured creditor's claim is in excess of the value of the encumbered asset, or the value of the secured claim as determined at commencement (where that approach is followed), the unsecured portion of the claim will generally be treated as an ordinary unsecured claim for purposes of distribution.

625. Some insolvency laws do not afford secured creditors a first priority. Payment of secured creditors may be ranked after costs of administration and other claims which are afforded the protection of priority, such as unpaid wage claims, tax claims, environmental claims and personal injury claims. Another approach is reflected in those laws which provide that the amount that can be recovered (in priority) by secured creditors from the assets securing their claim is limited to a certain percentage of that claim. In some of the laws which adopt that approach, a distinction is made between security interests over essentially all of the assets of a business (sometimes referred to as an enterprise mortgage or floating charge) and other types of security interest. The carved-out portion of the claim is generally used to serve the claims of other creditors, whether lower ranking priority creditors or ordinary unsecured creditors, or to pay the remuneration and expenses of the insolvency representative and costs in connection with the preservation and administration of the estate where the value of assets of the estate is insufficient to meet these costs. One of the rationales of this approach is that the secured creditor should share, in some equitable manner, some of the losses of other creditors in

liquidation and, in reorganization, some of the costs. Unless some portion of the debtor's assets are reserved for payment of those other claims, it is unlikely that they will share in a distribution. The adoption of these types of exceptions to the rule of first priority of secured creditors has the potential to create uncertainty with respect to the recovery of secured credit, thus discouraging the provision of secured credit and raising the associated costs. It is highly desirable that the use of such exceptions in an insolvency law is limited.

626. Where the secured claim is satisfied directly from the net realization proceeds of the asset concerned, the secured creditor, unlike unsecured creditors, generally will not contribute (either directly or indirectly) to the general costs of the insolvency proceeding, unless there are provisions such as noted above. However, the secured creditor still may be required in those cases to contribute to other costs directly related to its interests, such as the administrative expenses related to the maintenance of the encumbered asset. If the insolvency representative has expended resources in maintaining the value of the secured asset, it may be reasonable to recover those expenses as administrative expenses from the amount that would otherwise be paid in priority to the secured creditor from the proceeds of the sale of the asset. A further exception to the first priority rule may also relate to priorities provided in respect of post-commencement finance, where the effect on the interests of secured creditors of any priority granted should be clear at the time the finance is obtained, particularly since it may have been approved by the secured creditors (see chapter VI.B).

(ii) *Administrative costs and expenses*

627. The administrative expenses of the insolvency proceeding often have priority over unsecured claims, and generally are accorded that priority to ensure proper payment for the parties acting on behalf of the insolvency estate. These expenses would generally include remuneration of the insolvency representative and any professionals employed by the insolvency representative or in some cases the debtor; debts arising from the proper exercise of the insolvency representative's (or in some cases the debtor's) functions and powers (see chapter IV.A and B); costs arising from continuing contract obligations (e.g. labour and lease agreements); costs of the proceedings (e.g. court fees) and, under some insolvency laws, the remuneration of any professionals employed by a committee of creditors.

(iii) *Priority or privileged claims*

628. Insolvency laws often attribute priority rights to certain (mainly unsecured) claims which in consequence will be paid in priority to other, unsecured and non-privileged (or less privileged) claims. These priority rights, which are often based upon social, and sometimes political, considerations, militate against the principle of *pari passu* distribution and generally operate to the detriment of ordinary unsecured creditors by reducing the value of the assets available for distribution to them. The provision of priority rights has the potential to foster unproductive debate on the assessment of which creditors should be afforded priority and the justifications for doing so. The provision of these rights in an insolvency law also has an impact on the cost and availability of credit, which will increase as the amount of funds available for distribution to other creditors decreases.

629. Some priorities are based on social concerns that may more readily be addressed by other law, such as social welfare legislation, than by designing an insolvency law to achieve social objectives which are only indirectly related to questions of debt and insolvency. Providing a priority in the insolvency law may at best afford an incomplete and inadequate remedy for the social problem, while at the same time rendering the insolvency process less effective. Where priorities are to be included in an insolvency law or where priorities that exist in other laws will be recognized and have effect in insolvency proceedings, it is desirable that these priorities be clearly stated or referred to in the insolvency law (and if necessary ranked with other claims). This will ensure that the insolvency regime is at least transparent and predictable as to its impact on creditors and will enable lenders to more accurately assess the risks associated with lending.

630. In some recent insolvency laws there has been a significant reduction in the number of these types of priority rights, reflecting a change in the public acceptability of such treatment. A few countries, for example, have recently removed the priority traditionally provided to tax claims. In other countries, however, there is a tendency to increase the categories of debt that enjoy priority. Maintaining a number of different priority positions for many types of claims has the potential to complicate the basic goals of insolvency and to make efficient and effective proceedings difficult to achieve. It may create inequities and, in reorganization, complicates preparation of the plan. In addition, it should be remembered that adjusting the order of distribution to create these priorities does not increase the total amount of funds available for creditors. Rather, it will only result in a benefit to one group of creditors at the expense of another group. The larger the number of categories of priority creditors, the greater the scope for other groups to claim that they also deserve priority treatment. The greater the number of creditors receiving priority treatment, the less beneficial that treatment becomes.

631. Some of the factors that may be relevant in determining whether compelling reasons exist to grant privileged status to any particular type of debt may include the need to give effect to international obligations; the need to strike a balance between private rights and public interests and the alternative means available to address those public interests; the desirability of creating incentives for creditors to manage credit efficiently and to fix the price of credit as low as possible; the impact of creating certain preferences on transaction and compliance costs; and the desirability of drawing fine distinctions between creditors that result in one class of creditor having to bear a greater burden of unpaid debt.

632. Many different approaches are taken to the types of claims that will be afforded priority and what that priority will be. The types of priorities afforded by countries vary, but two categories are particularly prevalent. The first is a priority for employee salaries and benefits (social security and pension claims), and a second is for tax claims. Consideration of the priority of tax claims may be of particular concern in transnational cases. One approach might be to disallow priority for all foreign tax claims. An alternative might be to recognize some type of priority for such tax claims, perhaps limited in scope, either where there is reciprocity with respect to the recognition of such claims or where insolvency proceedings in respect of a single debtor are being jointly administered in more than one state. Article 13 of the UNCITRAL Model Law on Cross-Border Insolvency recognizes the importance of the non-discrimination principle with respect to the ranking of

foreign claims, but also provides that countries which do not recognize foreign tax and social security claims can continue to discriminate against them.<sup>110</sup>

- *Employee claims*

633. In a majority of countries, workers' claims (including claims for wages, leave or holiday pay, allowances for other paid absence, and severance pay) constitute a class of priority claims, which in a number of cases ranks above tax and social security claims. This approach is generally consistent with the special protection that is afforded to employees in other areas of insolvency law (see chapter III.D.6), as well as with the approach of some international conventions.<sup>111</sup> In some insolvency laws, the importance of maintaining continuity of employment in priority to other objectives of the insolvency process, such as maximization of value of the estate for the benefit of all creditors, is evidenced by a focus on sale of the business as a going concern (with the transfer of existing employment obligations), as opposed to liquidation or reorganization where these obligations may be altered or terminated.

634. In some countries, employee claims are afforded priority but will rank equally with taxes and social security claims in a single class of priority claims and may be satisfied proportionately in the event of insufficient funds. In other countries, no priority is provided for employee claims and they are ranked as ordinary unsecured claims, although in some cases payment of certain obligations accrued over specified periods of time (for example, for wages and remuneration arising within three months before commencement of insolvency proceedings) may be guaranteed by the State through a wage guarantee fund. The fund guaranteeing the payment of such claims may itself have a claim against the estate and may or may not have the same priority vis-à-vis the insolvency estate as the employee claims, depending upon policy considerations such as the use of public monies (as opposed to the assets of the insolvent debtor) for funding the provision of wage compensation. Usual practice would be for the fund to enjoy the same rights as the employee, at least in respect of a certain specified amount which may be denoted in terms of an amount of wages or a number of weeks of pay.

- *Tax claims*

635. Priority is often accorded to government tax claims on the basis of protecting public revenue. According a priority to such claims has been justified on a number of other grounds. These grounds include that it can be beneficial to the reorganization process because tax authorities will be encouraged to delay the collection of taxes from a troubled business on the basis that eventually they will be afforded a priority for payment under insolvency, and that because the government is a non-commercial and unwilling creditor, it may be precluded from some commercial debt recovery options. Providing a priority to such claims, however, can be counterproductive because failure to collect taxes can compromise the uniform enforcement of tax laws and may constitute a form of state subsidy which

<sup>110</sup> UNCITRAL Model Law on Cross-Border Insolvency, article 13(2) and footnote 2.

<sup>111</sup> For example, the ILO Protection of Workers' Claims (Employer's Insolvency) Convention, 1992 (No. 173). Article 8(1) provides that "national laws or regulations shall give workers' claims a higher rank of privilege than most other privileged claims, and in particular those of the State and social security system". The Convention entered into force in 1995.

undermines the discipline that an effective insolvency regime is designed to support. It may encourage tax authorities to be complacent about monitoring debtors and collecting debts in a commercial manner that would assist to prevent insolvency and the depletion of assets.

(iv) *Ordinary unsecured creditors*

636. Once all secured and priority creditors have had their claims satisfied the balance of the insolvency estate generally would be distributed pro rata to ordinary unsecured creditors. There may be subdivisions within the class, with some claims being treated as subordinate or with a priority as noted above. Some claims that generally are subordinated are discussed below.

(v) *Owners and equity holders*

637. Owners and equity holders may have claims arising from loans extended to the debtor and claims arising from their equity or ownership interest in the debtor. Many insolvency laws distinguish between these different claims. With respect to claims arising from equity interests, many insolvency laws adopt the general rule that the owners and equity holders of the business are not entitled to a distribution of the proceeds of assets until all other claims which are senior in priority have been fully repaid (including claims of interest accruing after commencement). As such, these parties will rarely receive any distribution in respect of their equity interest in the debtor. Where a distribution is made, it would generally be made in accordance with the ranking of shares specified in the company law and the corporate charter. Debt claims, such as those relating to loans, however, are not always subordinated.

(vi) *Related persons*

638. A category of creditors that may require special consideration is those persons related to the debtor, whether in a familial or business capacity (discussed above, see chapter II.E.3(e) and chapter V.A). Under some insolvency laws, these claims are always subordinated, and under other laws they are subordinated only on the basis of inequitable conduct or fraudulent or quasi-fraudulent conduct. Where they are subordinated, the claims may rank after ordinary unsecured claims. Other approaches for treatment of these claims do not relate to ranking, but to restrictions on voting rights or to the amount of the claim that will be admitted in the proceedings.

(vii) *Fines, penalties and post-commencement interest*

639. Some countries treat claims such as gratuities, fines and penalties (whether administrative, criminal or some other type) as ordinary unsecured claims, and subordinate them to other unsecured claims. In some insolvency laws these types of claims are treated as excluded claims.

640. Different approaches are taken to the accrual and payment of interest on claims. Some insolvency laws provide that interest on claims ceases to accrue on all unsecured debts once liquidation proceedings have commenced, but that payment in reorganization will depend upon what is agreed in the plan. In other cases where provision is made for interest to accrue after commencement of proceedings, payment may be subordinated and it will be paid only after all other unsecured claims have been paid.

## 2. Distribution

### (a) Liquidation

641. Where there are a number of different categories of claims with different priorities, each level of priority generally will be paid in full before the next level is paid. Once a level of priority is reached where there are insufficient funds to pay all the creditors in full, the creditors of that priority share pro rata. In some laws that do not establish different levels of priority, all the creditors share pro rata if there are insufficient funds to pay them in full.

### (b) Reorganization

642. A plan of reorganization may propose distribution priorities that are different to those provided by the insolvency law in a liquidation, provided that creditors voting on the plan approve such a modification. It may be desirable to provide in reorganization proceedings that priority claims must be paid in full as a predicate to confirmation of a plan unless the affected priority creditors agree otherwise (see chapter IV).

## Recommendations

### Purpose of legislative provisions

The purpose of provisions on priority and distribution is to:

- (a) establish the order in which claims should be satisfied from the estate ;
- (b) ensure that similarly ranked creditors are satisfied proportionately out of the assets of the estate;
- (c) specify limited circumstances in which priority in distribution is permitted.

### Contents of legislative provisions

#### *Classes and treatment of creditors affected by commencement of insolvency proceedings*

(170) The law should specify the classes of creditors that will be affected by the commencement of insolvency proceedings and the treatment of those classes in terms of priority and distribution.

#### *Establishing an order for satisfaction of claims*

(171) The law should establish the order in which claims are to be satisfied from the estate.

#### *Priority claims*

(172) The law should minimize the priorities accorded to unsecured claims. The law should set out clearly the claims that will be entitled to be satisfied in priority in insolvency proceedings.



*Secured claims*

(173) The law should specify that secured claims should be satisfied from the security in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the law. To the extent that the value of the security is insufficient to satisfy the secured creditor's claim, the secured creditor may participate as an ordinary unsecured creditor.

*Ranking of claims*

(174) The law should specify that claims other than secured claims, are ranked in the following order:

- (a) Administrative costs and expenses;
- (b) Claims with priority;
- (c) Ordinary unsecured claims;
- (d) Deferred or subordinated claims.<sup>112</sup>

(175) The law should specify that in the event that there is a surplus after all claims have been satisfied in full, the surplus is returned to the debtor.

*Distribution in liquidation*

(176) The law should provide, as a general principle, that similarly ranked claims are paid *pari passu*. All similarly ranked claims in a particular class should be paid in full before the next rank is paid.

(177) The law should specify that in making a distribution the insolvency representative is required to make provision for submitted claims that are not yet finally admitted.

(178) The law should specify that, in liquidation proceedings, distributions be made promptly and that interim distributions may be made.

## C. Treatment of corporate groups in insolvency

### 1. Introduction

643. It is common practice for commercial ventures to operate through groups of companies and for each company in the group to have a separate legal personality. Where a company in a group structure becomes insolvent, treatment of that company as a separate legal personality raises a number of issues which are generally complex and may often be difficult to address. In certain situations, such as where the business activity of a company has been directed or controlled by a related company, the treatment of the group companies as separate legal personalities may operate unfairly. That treatment, for example, may prevent access to the funds of one company for the payment of the debts or liabilities of a related

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<sup>112</sup>The law may provide for further ranking of claims within each of the ranks set forth in paras. (a), (b) and (d). Where all creditors within a rank cannot be paid in full, the order of payment should reflect any further ranking specified in the law for claims of the same rank.

debtor company (except where the debtor company is a shareholder or creditor of the related company), notwithstanding the close relationship between the companies and the fact that the related company may have taken part in the management of the debtor or acted like a director of the debtor and caused it to incur debts and liabilities. Furthermore, where the debtor company belongs to a group of companies, it may be difficult to untangle the specific circumstances of any particular case to determine which group company particular creditors dealt with or to establish the financial dealings between group companies.

644. Two issues of specific concern in insolvency proceedings involving one of a group of companies are:

(a) Whether any other company in the group will be responsible for the external debts of the insolvent company (being all debts owed by the insolvent company except for those owed to related group companies, i.e. “intra-group debts”); and

(b) Treatment of intra-group debts (claims against the debtor company by related group companies).

645. Insolvency laws provide different responses to these issues. Some laws adopt a prescriptive approach which strictly limits the circumstances in which group companies can be treated as other than separate legal personalities, in other words, the circumstances in which a related company can be responsible for the debts of an insolvent group member. Other laws adopt a more expansive approach and give courts broad discretion to evaluate the circumstances of a particular case on the basis of specific guidelines. The range of possible results in the latter case is broader than under those laws adopting a prescriptive approach. In either case, however, it is common for insolvency laws to address these issues of intra-group liability based upon the relationship between the insolvent and related group companies in terms of both shareholding and management control. One possible advantage of addressing these issues in an insolvency law is to provide an incentive for corporate groups to continuously monitor the activities of companies within the group, and take early action in the case of financial distress of a member of that group. Treating companies as other than separate legal entities however, may undermine the capacity of business, investors and creditors to quarantine, and make choices about, risk (which may be particularly important where the group includes a company with special requirements for risk management, such as a financial institution); it may introduce significant uncertainty that affects the cost of credit, particularly when the decision about responsibility for group debts is made by a court after the event of insolvency; and it may involve accounting complexities concerning the manner in which liabilities are treated within the group.

## **2. Group responsibility for external debts**

646. Insolvency regimes look to a number of different circumstances or factors in the assessment of whether a related or group company should bear responsibility for the external debts of an insolvent member of the group.

647. It is common to many jurisdictions for the related company to bear responsibility for the debt where it has given a guarantee in respect of its subsidiaries. Similarly, many regimes infer responsibility to compensate for any loss or damage in cases of fraud in intra-group transactions. Further solutions may be

prescribed by other areas of law. In some circumstances, for example, the law may treat the insolvent company as an agent of the related company, which would permit third parties to enforce their rights directly against the related company as a principal.

648. Where the insolvency law grants the courts a wide discretion to determine the liability of one or more group companies for the debts of other group companies, subject to certain guidelines, those guidelines may include the following considerations: the extent to which management, the business and the finances of the companies are intermingled; the conduct of the related company towards the creditors of the insolvent company; the expectation of those creditors that they were dealing with one economic entity rather than two or more group companies; and, the extent to which the insolvency is attributable to the actions of the related group company. Based on these considerations, a court may decide on the degree to which a corporate group has operated as a single enterprise and, in some jurisdictions, may order that the assets and liabilities of the companies be consolidated or pooled,<sup>113</sup> particularly where that order would assist in a reorganization of the corporate group, or that a related company contribute financially to the insolvent estate, provided that contribution would not affect the solvency of the contributing company. Contribution payments would generally be made to the insolvency representative administering the insolvent estate for the benefit of the estate as a whole.

649. One further and important consideration in insolvency laws that allow such measures is the effect of those measures on creditors. These regimes, in seeking to ensure fairness to creditors as a whole, must reconcile the interests of two (or more) sets of creditors who have dealt with two (or more) separate corporate entities. These collective interests will conflict if the total assets of the combined companies are insufficient to meet all claims. In such a case, creditors of a group company with a significant asset base would have their assets diminished by the claims of creditors of another group company with a low asset base. One approach to this issue is to consider whether the savings to creditors collectively would outweigh the incidental detriment to individual creditors. In the situation where both companies are insolvent, some laws take into account whether the withholding of a consolidation decision, ensuring separate insolvency proceedings, would increase the cost and length of proceedings and deplete funds which would otherwise be available for creditors, as well as allowing the shareholders of some corporate group companies to receive a return at the expense of creditors in other group companies.<sup>114</sup>

650. The common principle of all regimes with laws of this type is that, for a consolidation order to be granted, the court must be satisfied that creditors would suffer a greater prejudice in the absence of consolidation than the insolvent companies and objecting creditors would from its imposition. In the interests of fairness, some jurisdictions allow for partial consolidation by exempting the claims of specific creditors and satisfying these claims from particular assets (excluded from the consolidation order) of one of the insolvent companies. The difficulties

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<sup>113</sup> A decision that a corporate group has operated as one economic entity will give rise to application of other provisions of the insolvency law, for example, the duty of directors to prevent insolvent trading. Some laws also allow, in limited circumstances, companies to voluntarily pool assets and liabilities.

<sup>114</sup> Some laws require creditors, as well as assets and liabilities, of each relevant group company to be separately identified before any distribution can be made.

imposed by this reconciliation exercise have resulted in such orders being infrequently made in those countries where they are available.

651. It should be noted that insolvency laws providing for consolidation do not affect the rights of secured creditors, other than possibly the holders of intra-group securities (where the secured creditor is a group company).

### **3. Intra-group debts**

652. Intra-group debts may be dealt with in a number of ways. As discussed above (see chapter II.E), intra-group transactions may be subject to avoidance actions. Under some insolvency laws that provide for consolidation, intra-group obligations are terminated by the consolidation order. Other approaches involve classifying intra-group transactions differently from similar transactions conducted between unrelated parties (e.g. a debt may be treated as an equity contribution rather than as an intra-group loan) with the consequence that the intra-group obligation will rank lower in priority than the same obligation between unrelated parties.

## **D. Applicable law governing in insolvency proceedings**

(Note: The section on applicable is currently being developed and a final draft will be available for consideration by the Working Group at its 30th session in 2004. The revised recommendations set forth below reflect the discussion at the 29th session of the Working Group in September 2003.)

### **Recommendations**

#### **Purpose of legislative provisions**

The purpose of provisions on the applicable law governing insolvency proceedings is to:

- (a) facilitate commerce by providing a clear and transparent basis for predicting the law that will apply in the context of insolvency proceedings;
- (b) provide courts with clear and predictable rules for determining the law applicable in the context of insolvency proceedings [including enforcement of contractual choice of law provisions].

#### **Contents of legislative provisions**

##### *Law of the insolvency proceedings*

(179) The insolvency law should provide of the place where insolvency proceedings are commenced should apply to all aspects of the conduct, administration and conclusion of those insolvency proceedings, including:

- (a) eligibility and commencement criteria;
- (b) creation and scope of the insolvency estate;
- (c) treatment of property of the estate, including the scope of, exceptions to, and relief from application of a stay;

- (d) costs and expenses;
- (e) proposal, approval, confirmation and implementation of a plan of reorganization;
- (f) the voidness, voidability or unenforceability of legal acts detrimental to creditors;
- (g) effect of the commencement of the proceedings upon contracts under which both the debtor and its counterparty have not yet fully performed their respective obligations, including the enforceability of automatic termination and anti-assignment provisions in those contracts;
- (h) conditions under which setoff can occur after commencement of insolvency proceedings;
- (i) rights and obligations of the debtor, insolvency representative, creditors and creditors' committee;
- (j) claims and their treatment;
- (k) priorities for ranking of claims;
- (l) distribution of proceeds of liquidation; and
- (m) resolution and conclusion of the proceedings.

*Exception to application of law of the insolvency proceedings*

(180) As an exception to recommendation (1)(f) and (h), the insolvency law may provide that the law of another State applies to set-off or to the avoidability of a transaction that occurred before the application for commencement or the commencement of insolvency proceedings.<sup>115</sup>

*Validity of contractual choice of law provisions*

(181) The insolvency law should recognize contractual provisions in which the debtor and its counterparty expressly agree that the law applicable to their legal relationship under the contract will be the law of a specified jurisdiction without regard to the nexus between the transaction or the parties at issue and the chosen applicable law, except where such a provision is viewed as manifestly contrary to public policy [of the jurisdiction whose law would apply in the absence of such a provision].

*Determining the applicable law*

(182) The insolvency law should clearly indicate when the insolvency law would allow the application of the laws of another jurisdiction.

(183) As to the application of law other than insolvency law, the insolvency court will need to apply a conflict of laws rule to determine which State's law should apply. The conflict of laws rules should be clear and predictable and should follow

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<sup>115</sup> The use of the word "transaction" in this section is intended to refer generally to the wide range of legal acts by which assets may be disposed of or obligations incurred including by way of a transfer, a payment, a security, a guarantee, a loan or a release [or an action making a security interest effective against third parties] and may include a composite series of transactions.

modern conflict of laws rules embodied in international treaties and legislative guides sponsored by international bodies.

## VI. Conclusion of proceedings

### A. Discharge

#### 1. Discharge of the debtor in liquidation<sup>116</sup>

653. Following distribution in the liquidation of the estate of a natural person debtor, it is likely that a number of creditors will not have been paid in full. An insolvency law will need to consider whether these creditors will still have an outstanding claim against that individual debtor or, alternatively, whether the debtor will be released or “discharged” from those residual claims.

654. When the debtor is a limited liability company, the question of discharge following liquidation does not arise; either the law provides for the disappearance of the legal entity or, alternatively, that it will continue to exist as a shell with no assets. The shareholders will not be liable for the residual claims and the issue of their discharge does not arise. If the debtor’s business takes a different form, such as a sole proprietorship, a group of individuals (a partnership), or an entity whose owners have unlimited liability, the question arises as to whether these individuals will still be personally liable for unsatisfied claims following liquidation.

655. There is an increasing awareness in some circles of the need to recognize business failure as a natural feature of the economy and to accept that both weak and good businesses can fail, albeit for different reasons, without necessarily involving irresponsible, reckless or dishonest behaviour on the part of the management of the business. A person who has failed in one business may have learned from that experience and some studies suggest that they are often very successful in later business ventures. For these reasons, a number of countries have taken the view that their insolvency regime needs to focus not only on addressing the administration of failure, but also upon facilitating a fresh start for insolvent debtors by clearing their financial situation and taking other steps to reduce the stigma associated with business failure, rather than upon punishment of the debtor. In addition to adapting the insolvency law to remove unnecessary conditions and restrictions on discharge, there is a need to encourage banks and the wider community to take a different view of business failure, and to provide assistance and support to those involved. At the same time, the insolvency regime needs to protect the public and the commercial community from those debtors whose conduct of their financial affairs has been irresponsible, reckless or dishonest.

656. Insolvency laws adopt different approaches to the question of discharge. In some, the debtor remains liable for unsatisfied claims, subject to any applicable limitation periods (which in some cases might be quite long, for example, 10 years) and may also be subject to a number of conditions and restrictions relating to professional, commercial and personal activities. This type of rule emphasizes the value of a debtor-creditor relationship: the continued responsibility of the debtor following liquidation is intended to both moderate a debtor’s financial behaviour

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<sup>116</sup> These paragraphs relate to discharge of a debtor who is a natural person.

and encourage a creditor to provide financing. At the same time, it may work to inhibit opportunity, innovation and entrepreneurial activity because the sanctions for failure are severe.

657. Other insolvency laws provide for a complete discharge of an honest, non-fraudulent debtor immediately following liquidation. This approach emphasizes the benefit of the “fresh start” that discharge brings and is often designed to encourage the development of an entrepreneurial class. It is also a recognition that over-indebtedness is a current economic reality and should be addressed in an insolvency law. A third approach attempts to strike a compromise: discharge is granted after a period following distribution, during which the debtor is expected to make a good faith effort to satisfy its outstanding obligations.

658. Some insolvency laws adopt the approach that in some circumstances, it may be appropriate to limit the availability of discharge. These circumstances vary from law to law but may include where the debtor has acted fraudulently; engaged in criminal activity; violated employment or environmental laws; failed to keep appropriate records; failed to participate in the insolvency proceedings in good faith or to cooperate with the insolvency representative; failed to provide or actively withheld or concealed information; continued trading at a time when it knew it was insolvent; incurred debts with no reasonable expectation of being able to pay them; and concealed or destroyed assets or records after the application for commencement.

659. Different approaches are taken to the conditions that will apply to discharge in these types of circumstances. In some countries, the period before a discharge is given may be quite long or conditions and restrictions will apply to the discharge, or a combination of both. Certain types of debts may be excluded from the discharge, such as tort claims; claims arising from maintenance agreements (payments to a divorced spouse or to support children of the debtor); fraud; debts based on penalties where the alternative is a gaol sentence and taxes.

660. Conditions may also be imposed upon the debtor, both during the proceedings or as a condition for a discharge, either by way of recommendation by the insolvency representative or by the court. These conditions may include restrictions on the ability of the debtor to obtain new credit, to leave the country, to carry on business for a certain period of time or a ban, where relevant, on practising its profession for a period of time. They may also include a discharge that is provided on the condition that the debtor does not subsequently acquire a substantial new fortune from which previous debts could be paid. The length of the application of these provisions varies, depending upon the situation of the debtor. Other limitations adopted by insolvency laws relate to the number of times a debtor can be discharged. In some jurisdictions, a discharge is a once in a lifetime opportunity; in others there is a minimum waiting period, for example, 10 years, before a debtor will qualify for a new discharge, or even be able to enter insolvency proceedings which may lead to a new discharge. A further approach restricts discharge where, for example, the debtor has been given a discharge within a certain period of time before commencement of the current proceedings and where the payments made in those proceedings were less than a fixed percentage.

661. The choice between these different alternatives involves weighing the underlying rationale of the insolvency proceedings and the provision of a discharge

against the need to sanction certain behaviour. A distinction might be drawn between behaviour that is inappropriate and perhaps negligent, and behaviour that would amount to criminal misconduct. If the underlying purpose of the insolvency law is to resolve the financial difficulties of the debtor and provide for a fresh start to encourage entrepreneurial activity and risk taking, an honest and cooperative debtor that has performed its obligations under the insolvency law can be discharged after liquidation with minimal restrictions. An approach that imposes severe restrictions upon such debtors and provides for discharge only after long periods of time and the fulfilment of many conditions suggests an underlying purpose of punishing, rather than rehabilitating the debtor. Imposing conditions and restrictions might be more appropriate in cases where the debtor has not been honest, has not cooperated with the insolvency representative or performed its obligations under the insolvency law or in more extreme cases, has been guilty of criminal misconduct.

662. An additional consideration is the connection between the conditions imposed and the basic rationale of discharge. The imposition of certain broad conditions, such as prohibiting the debtor from engaging in business activities, may be inconsistent with the basic notion of providing a discharge. Depending upon the circumstances, more limited conditions such as limiting the debtor's ability to serve on a board of directors might be more appropriate. Where an insolvency law adopts the approach of imposing conditions and exempting certain debts from discharge, it is desirable that those conditions and exemptions be kept to a minimum. To the extent possible, types of debt to be exempted should be set forth in the insolvency law to ensure transparency and predictability.

663. Some insolvency laws also provide that where a discharge is given at an early stage of the proceedings it can be suspended where, for example, the debtor fails to comply with an obligation, or revoked, where for example, the discharge was obtained by fraud, the debtor fraudulently withheld information concerning property that should be part of the estate, or failed to comply with orders of the court.

664. One issue that may need to be taken into account in considering discharge of individuals engaged in a business undertaking is the intersection of business indebtedness with consumer indebtedness. Recognizing that different approaches are taken to the insolvency of natural persons (in some countries a natural person cannot be declared bankrupt at all, in others there is a requirement for the person to have acted in the capacity of a "merchant") and that many countries do not have a developed consumer insolvency system, a number of countries do have insolvency laws that seek to distinguish between those who are simply consumer debtors and those whose liabilities arise from small businesses. Since consumer credit often is used to finance small business either as start-up capital or for operating funds, it may not always be possible to separate the debts into clear categories. For that reason, where a legal system recognizes both consumer and business debt, it may not be feasible to have rules on the business debts of natural persons that differ from the rules applicable to consumer debts.

## **2. Discharge of debts and claims in reorganization**

665. To ensure that the reorganized debtor has the best chance of succeeding, an insolvency law can provide for a discharge or alteration of debts and claims that have been discharged or otherwise altered under the plan. This approach supports



the goal of commercial certainty by giving binding effect to the forgiveness, cancellation or alteration of debts in accordance with the approved plan. The principle is particularly important to ensure that the plan provisions will be complied with by creditors that rejected the plan and by creditors that did not participate in the process. It also gives certainty to other lenders and investors that they will not be involved in unanticipated liquidation or have to compete with hidden or undisclosed claims. Thus the discharge establishes unequivocally that the plan fully addresses the legal rights of creditors.

666. Discharge in reorganization might be effective from the time the plan becomes effective under the insolvency law or from the time it is fully implemented. In the event that the plan is not fully implemented or implementation fails, an insolvency law many insolvency laws provide that the discharge can be set aside.

## **Recommendations**

### **Purpose of legislative provisions**

The purpose of provisions on discharge is to:

- (a) enable an a natural person debtor to be finally discharged from liabilities for pre-commencement debts, thus providing the debtor with a fresh start;
- (b) establish the circumstances under which discharge will be granted and the terms of that discharge.

### **Contents of legislative provisions**

#### *Discharge in liquidation*

(184) Where natural persons are eligible as debtors under the insolvency law, the issue of discharge of the debtor from liability for pre-commencement debts should be addressed. The insolvency law may specify that the discharge may not apply until after the expiration of a specified period of time following commencement, during which period the debtor is expected to cooperate with the insolvency representative. Upon the expiration of such time period, the debtor may be discharged where the debtor has not acted fraudulently and has cooperated with the insolvency representative in performing its obligations under the insolvency law. The law may specify that the discharge be revoked where it was obtained fraudulently.

(185) Where the insolvency law provides that certain debts are excluded from the discharge such debts should be kept to a minimum to facilitate the debtor's fresh start and should be set forth in the insolvency law. Where the insolvency law provides that the discharge may be subject to conditions, those conditions should be kept to a minimum to facilitate the debtor's fresh start.

## **B. Conclusion of proceedings**

667. Insolvency laws adopt different approaches to the manner in which a proceeding is to be concluded or closed, the pre-requisites for closure and the procedures to be followed.

## 1. Liquidation

668. A number of insolvency laws adopt an approach that generally requires, following realisation of assets and distribution, that the insolvency representative call a meeting of creditors and present a final accounting. Provided that creditors agree to the accounting, all that is then required under some laws (where the debtor is a corporate entity) is that the final accounts and a report of the final meeting be filed with the administrative body responsible for registration of corporate entities and the debtor entity will be dissolved, while other laws require a formal application to the court for an order for dissolution. Some variations on this general approach include slightly different procedures for proceedings commenced on debtor and creditor applications.

## 2. Reorganization

669. In general, insolvency laws adopt one of two or three approaches to the conclusion of reorganization proceedings. Reorganization proceedings may be treated as concluded when the reorganization plan is approved (and confirmed where this is required)(see chapter IV.A.6); where the liabilities have been discharged in accordance with the plan and the plan has otherwise been fully implemented (with or without the need for a formal court order, although some laws make provision for the insolvency representative to be discharged from its duties by a formal order of the court); and where the court orders the proceedings to be dismissed because they constituted an improper use of the insolvency law or the debtor did not meet the commencement criteria at the time of commencement. Proceedings may also be concluded in accordance with the terms of the plan or some other contractual agreement with creditors. Where the reorganization plan is not fully implemented, the insolvency law may provide for the court to convert the proceedings to liquidation, in order to avoid the debtor being left in an insolvent state with its financial situation unresolved. Whether this may constitute a formal conclusion of the reorganization proceedings and commencement of liquidation proceedings depends upon the approach of the jurisdiction in question. Where the reorganization proceedings conclude once the plan has been approved (and confirmed, where this is required) rights and obligations included in the plan will be enforced under non-insolvency law.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions on conclusion of proceedings is to determine a procedure for concluding the proceedings once the goal of those proceedings has been achieved.

### Contents of legislative provisions

#### *Liquidation*

(186) The law should specify that liquidation proceedings should be closed following final distribution or a determination that no distribution can be made.

*Reorganization*

(187) The law should specify that reorganization proceedings should be closed when the reorganization plan is fully implemented or at an earlier date determined by the court.

**F. Note by the Secretariat on the treatment of security interests in the draft legislative guide on insolvency law, working paper submitted to the Working Group on Insolvency Law at its thirtieth session**

**(A/CN.9/WG.V/WP.71) [Original: English]**

1. At its thirty-fifth session (2002), the Commission noted with particular satisfaction the efforts undertaken by Working Group VI (Security Interests) and Working Group V (Insolvency Law) towards coordinating their work on a subject of common interest, the treatment of security interests in insolvency proceedings. Strong support was expressed for such coordination, which was generally thought to be of crucial importance for providing States with comprehensive and consistent guidance regarding the treatment of security interests in insolvency proceedings. The Commission endorsed a suggestion made to revise chapter X, Insolvency, of the draft legislative guide on secured transactions in light of the core principles agreed by Working Groups V and VI (see A/CN.9/511, paras. 126-127 and A/CN.9/512, para. 88). The Commission also endorsed a suggestion for closer coordination of the work of the two Working Groups, including by holding a one-day joint meeting of the two Working Groups at their upcoming sessions.<sup>1</sup>
2. At their first joint session (Vienna, 16-17 December 2002), Working Groups V and VI considered the treatment of security rights in insolvency proceedings on the basis of chapter IX, Insolvency, of the draft legislative guide on secured transactions (A/CN.9/WG.VI/WP.6/Add.5). At that session, the Secretariat was requested to prepare a revised version of chapter IX, Insolvency (see A/CN.9/535, para. 8).
3. At its thirty-sixth session (2003), the Commission expressed its appreciation to Working Groups V and VI for the progress made during their first joint session on matters of common interest and noted with satisfaction the plans for further joint meetings of experts.<sup>2</sup>
4. At its fourth session (Vienna, 8-12 September 2003), Working Group VI considered the revised version of chapter IX (A/CN.9/WG.VI/WP.9/Add.6) and requested the Secretariat to prepare a further revision (see A/CN.9/543, para. 15).
5. Working Groups V (Insolvency) and VI (Security Interests) will hold their second joint session on 26 March 2004. The purpose of the joint session is to confirm the treatment in the draft legislative guide on insolvency law (document A/CN.9/WG.V/WP.70 (Parts I and II)) of secured creditors in insolvency proceedings with respect to a number of issues raised at the fourth session of Working Group VI in September 2003.<sup>3</sup> The Commission has requested Working

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<sup>1</sup> *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/57/17)*, para. 203.

<sup>2</sup> *Ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 217.

<sup>3</sup> Report of Working Group V (Security Interests) on the work of its fourth session (September 2003) A/CN.9/543, paras 81-83.

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Group V to complete its work on the draft legislative guide and refer it to the thirty-seventh session of the Commission in 2004 for finalization and adoption.

6. The issues relating to the treatment of security interests are set forth in the table attached to this note. The treatment of those issues in the draft legislative guide on insolvency law is set forth, in summary, in the fourth column, with the second and third columns referring to the relevant chapters of the draft legislative guide.

7. Amongst the issues noted in the attached table, the Working Groups may wish to consider whether the following issues, in particular, should be dealt with more fully in the insolvency guide:

(a) Application of the stay and avoidance provisions to the perfection of a security interest (see issues 3 and 18);

(b) Determination of economic value of security interests (especially timing of valuation) (see issues 7 and 9);

(c) Treatment of secured creditors in reorganization where they disagree with, or abstain from voting on, the reorganization plan (see issues 23-28);

(d) Derogations from the first priority of secured creditors (see issues 32-33);

(e) Treatment of subordination agreements (see issue 34); and

(f) Treatment of title arrangements (see issues 36-43).

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
1. Are encumbered assets part of the estate?	Assets constituting the insolvency estate	II.A	<p>Rec. 24(a) provides “The law should identify the assets that will constitute the estate, including ... the debtor’s interest in assets subject to a security interest and in third-party-owned assets as at [the time of application for commencement] [commencement] of insolvency proceedings” (see also paras. 156, 159-161). Paras. 159-160 discuss reasons for including encumbered assets and note that while commencement of proceedings may limit or suspend the exercise of security rights, the insolvency law should make it clear that creditors are not deprived of their rights altogether.</p> <p><i>Note to the Working Groups: Is the reference to the “debtor’s interest in assets” sufficient to cover all intended circumstances? Will it, for example, capture the debtor’s interest in a transfer of title arrangement where the law does not provide for the debtor to retain an equitable property right or a right of redemption in the assets? If the debtor must rely in such situations on contractual or legislative rights, should the current formulation include a specific reference to such rights?</i></p>
2. What is the scope and time of the application of the stay?	Protection and preservation of the insolvency estate	II.B	<p>The guide provides that provisional measures (including a stay) may be granted by a court to apply between application for and commencement of insolvency proceedings (rec. 27) and that on commencement a stay or suspension should apply to certain actions (rec. 34), specifically:</p> <p>“(a) commencement or continuation of individual actions or proceedings concerning the assets of the debtor, and the rights, obligations or liabilities of the debtor; (b) [perfection] [actions to make security interests effective against third parties] or enforcement of security interests; (c) execution or other enforcement against assets of the estate; (d) the right of a counterparty to terminate any contract with the debtor; and (e) the right to transfer, encumber or otherwise dispose of any assets of the estate.” The stay would apply to actions taken by the debtor and by creditors or third parties, and would include creation of an encumbrance by the debtor after commencement.</p> <p>Secured creditors may request relief from the stay (see 5 below).</p>
3. Should the stay extend to acts of perfection of security interests?			<p>Rec. 27(a) provides that provisional measures may include, inter alia “(a) staying execution against the assets of the debtor, including [perfection] [actions to make security interests effective against third parties] or enforcement of security interests”; see also rec. 34.</p> <p>See generally para.181. Footnote 35 to para.189 notes that “Where a secured transactions regime provides a grace period for perfection of a security interest, whether the insolvency law should recognize that grace period and include an exception to application of the stay to secured creditors to permit perfection in the applicable circumstances also will need to be considered.”</p>

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
4. What is the duration of application of the stay?			<p>Rec. 37(c) provides “The law should specify that the measures applicable on commencement of insolvency proceedings remain effective throughout the proceedings until (a) relief is granted; (b) a reorganization plan becomes effective; or (c) in the case of secured creditors in liquidation proceedings, a fixed time period specified in the law expires, unless it is extended by the court for further period on showing that: (i) an extension is necessary to maximize the value of assets for the benefit of creditors; and (ii) the secured creditor will be protected against the erosion of the value of the encumbered asset.”</p> <p>Footnote 52 to rec. 37(c) notes that it is intended the stay should apply to secured creditors in liquidation proceedings only for a short period of time, such as between 30 and 60 days, and that the law should clearly state the period of application.</p>
5. On what grounds can the secured creditor be granted relief from the stay?			<p>Rec. 38 provides “... a secured creditor may request the court to grant relief from the type of measures applicable on commencement on grounds that may include that:</p> <p>(a) the encumbered asset is not necessary to a prospective reorganization or sale of debtor’s business; (b) [where the value of the secured claim exceeds the value of the encumbered asset] the value of the encumbered asset is eroding and the secured creditor is not protected against the erosion of that value; and (c) in reorganization, a plan is not approved within any applicable time limits.”</p> <p>Other relevant circumstances for relief from the stay discussed (see paras 200, 207) include where provision of protection of value is not feasible or is overly burdensome to the estate or where relief is required to protect or preserve value of assets, such as perishable goods.</p>
6. Aside from relief from the stay, what are the conditions for, and types of, protection that might be granted to secured creditors?			<p>Rec. 39 provides “... a secured creditor may request the court to grant protection. Where the value of the encumbered asset does not exceed the secured claim or will be insufficient to meet the secured claim if the value of the encumbered asset erodes during the imposition of the measures applicable on commencement, protection may include: (a) cash payments by the estate; (b) provision of additional security; or (c) such other means as the court determines.”</p> <p>Other measures discussed (see paras. 160, 189, 206) include maintaining the value of encumbered assets or the secured portion of a creditors claim; payment of interest; and consulting secured creditors on use and sale of encumbered assets. Para. 206 notes that approaches to protection need to be weighed against potential complexity and cost.</p> <p>Third-party-owned assets: para. 237 notes that the law should consider protection against diminution in value as for secured creditors.</p>

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
7. What “value” will be protected?			Paras. 210-215 discuss various approaches to protection of value. The first approach discussed is reflected in rec. 39 (see 6 above). A second approach discussed (but not currently reflected in recommendations) is to protect the value of the secured portion of the claim—the asset is valued upon commencement, and the amount of the secured portion of claim is determined. This remains fixed through the proceedings and is distributed at conclusion. It is noted that under some laws there may be payment of interest.
8. If necessary, how might the security be “replaced”?			Para. 214 notes that where it is necessary for the insolvency representative to sell encumbered assets, it is “desirable for an insolvency law to allow the insolvency representative the choice of providing the creditor with substitute equivalent security, such as a replacement lien over another asset or the proceeds of the sale of the encumbered asset, or paying out the full amount of the value of the assets that secure the secured claim either immediately or through an agreed payment plan”.  The law may restrict use of proceeds of sale of encumbered assets (see 13 below).
9. When and how will the economic value of a security right be determined?			Paras. 213-214 address the various purposes for which valuation of encumbered assets is required and note the need for the insolvency law to identify the date for determining value—the example given is the value at commencement, with provision for ongoing review. Methods of valuation discussed include by agreement of the parties; others are court-based including the use of experts, market comparisons and/or the application of principles stated in the insolvency law.  There are no specific recommendations as to the method or time of valuation.
10. Post-commencement restraints on enforcement of security rights, including whether security agreement is a contract that has not yet been fully performed.			See II.B Application of the stay and II.E Treatment of contracts. The guide talks generally about contracts where both parties have not fully performed their obligations (para. 257), noting that exceptions to the general rules on contracts may be needed for certain contracts, for example, labour contracts, contracts for the provision of personal services, financial contracts, contracts for loans and contracts for insurance (para. 259). Security agreements are not specifically discussed.
11. What power does the insolvency representative have to use or sell encumbered assets?	Use and disposal of assets	II.C	Recs. 40, 43 and 44 provide that the law should permit the use and disposal by the insolvency representative of assets of the estate, including assets subject to security interests, both in and outside the ordinary course of business, provided that: there is notice of the proposed sale or other disposal to secured creditors; secured creditors are given an opportunity to object to any proposed sale; relief from the stay has not been granted; and priority of interests in the proceeds of sale is preserved.



Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
			<p>Paras. 229-230 discuss various approaches to use or disposal of encumbered assets (other than by further encumbrance). Para. 231 discusses different approaches to the sale of encumbered assets free and clear of encumbrances and notes the different conditions that are imposed in insolvency laws including that the sale price must exceed the value of the security interest, or that the secured creditor could be compelled (in other legal proceedings) to accept cash or substitute equivalent security in settlement; and that the court may authorize the sale if the secured creditor does not consent. It notes further that where an inadequate offer is made, the secured creditor may be permitted to offset bid.</p> <p>Urgent sales: rec. 46 provides that the law should permit urgent sales “where the assets by their nature or because of other circumstances, are perishable, susceptible to devaluation or otherwise in jeopardy. The law may provide that prior approval of the court or of creditors is not in such circumstances”.</p> <p>Power of secured creditor to sell: para. 229 notes that if encumbered assets are not part of the estate, secured creditor can sell; otherwise it will normally be the insolvency representative that has the power but there may be limitations on exercise of that power, especially in liquidation, and in certain situations the insolvency representative may relinquish encumbered assets.</p>
12. When can encumbered assets be surrendered to secured creditor?			<p>Rec. 48: “... where a secured claim exceeds the value of the encumbered asset, and the asset is not required for a reorganization or sale of the business as a going concern, the law may permit the insolvency representative to relinquish the asset to the secured creditor without notice to other creditors”.</p> <p>Assets may also be relinquished where it is in the interests of estate, or the secured creditor obtains relief from stay. Other situations discussed (para. 234) include: where assets have no, or an insignificant, value to the estate; where the asset is burdened in such a way that retention would require excessive expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money; or where the asset is unsaleable or not readily saleable by the insolvency representative, such as where the asset is unique or does not have a readily apparent market or market value.</p>
13. Who is entitled to the proceeds of encumbered assets received from post-commencement dealings and events? Can proceeds for this purpose include both replacement assets and closely associated revenue? (see 8 above)			<p>Paras. 238-239 note that most laws provide that the secured creditor holds the equivalent interest in cash proceeds from the disposal of the encumbered asset. Proceeds may be used with the consent of the secured creditor or the court. Under some laws, certain issues may need to be resolved before a court will authorize such use: both the relevant security interest and the value of the underlying property will need to be determined; the risk to the secured creditor will need to be identified; and the court will need to determine whether sufficient measures are in place to protect the economic value of the secured claim.</p>

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
14. What types of post-commencement secured finance can be obtained? How is the priority of the provider of new secured finance reconciled with pre-commencement secured creditors?	Post-commencement finance	II.D	Rec. 50: "The law should enable a security interest to be granted for repayment of post-commencement finance, including a security interest on unencumbered assets, including after-acquired assets, or a junior or lower priority security interest on already encumbered assets of the estate." (See also 15 below.) Paras. 247-250 discuss the provision of security and priority.
15. Must an existing secured creditor agree to new secured finance? (see "Priming lien")			<p>Rec. 51: "The law should specify that a security interest over the assets of the estate to secure post-commencement finance does not have priority ahead of any existing security interest over the same assets unless the insolvency representative obtains the agreement of the existing secured creditor(s) or follows the procedure in recommendation (52)."</p> <p>Rec. 52: "... where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interest provided specified conditions are satisfied, including:</p> <ul style="list-style-type: none"> <li>(a) the existing secured creditor was given the opportunity to be heard by the court;</li> <li>(b) the debtor can prove that it cannot obtain the finance in any other way;</li> <li>(c) the interests of the existing secured creditor will be protected, including by a sufficient excess in the value of the encumbered asset so that the existing secured creditor will not be exposed to an unreasonable risk of harm." <p>Other conditions discussed (para. 250) might include providing protection for any diminution of the economic value of encumbered assets.</p> </li></ul>
16. Is super-priority restricted to secured creditors who finance acquisition of new assets by way of title retention or secured loan?			Not specifically addressed.
	Treatment of contracts	II.E	The guide provides generally that automatic termination clauses should be unenforceable as against the insolvency representative and the debtor (rec. 56); and that the insolvency representative may decide to continue to perform or reject a contract under which both the debtor and its counterparty have not yet fully performed their obligations (recs. 58-71).

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
17. Should secured transactions be included within the general rules governing avoidance of transactions in insolvency?	Avoidance actions	II.F	Rec. 74: “(a) where a security interest is effective and enforceable under other law, that effectiveness and enforceability will be recognized in insolvency proceedings” and (b) notwithstanding that a security interest is effective and enforceable under other law, it may be subject to the avoidance provisions of the insolvency law on the same grounds as other transactions” (see also paras. 322-324).
18. Should security rights created or perfected within a prescribed period before commencement be subject to avoidance?			Para. 325 notes the approach, under some insolvency laws, of avoidance provisions applying to a security interest that was not perfected under the relevant secured transactions law or to a security interest perfected within a short period before the commencement of proceedings. This issue is not addressed in the recommendations.
19. What will be the length of the suspect period for avoiding a secured transaction?			Rec. 75: “The law should specify that the transactions described in recommendation 73(a)-(c) may be avoided if they occurred within a specified period (the suspect period) calculated retroactively from a specified date, being either the application for or commencement of the insolvency proceedings. The law may specify different suspect periods for different types of transactions”. There are no specific recommendations as to length of the suspect period for any of these types of transactions, although different approaches are discussed (see paras. 332-335) and it is noted that where the transactions involve creditors who are not related persons, the suspect period may be brief (examples range from three to six months).
	Rights of set-off	II.G	No specific reference to secured transactions. See paras. 349-352 and rec. 85.
	Financial contracts and netting	II.H	Rec. 88: “Once the financial contracts of the debtor have been terminated, the law should permit counterparties to enforce and apply their security interest to obligations arising out of financial contracts. Financial contracts should be exempt from any stay under the insolvency law that applies to the enforcement of a security interest”.
20. Can secured creditors participate in insolvency proceedings?	Creditors— participation in insolvency proceedings	III.C	Rec. 110 establishes that all creditors, both secured and unsecured, are entitled to participate in insolvency proceedings and that the law should identify what that participation may involve in terms of the functions that may be performed.
21. How might secured creditors participate in insolvency proceedings?			Recommendations 110-120 on participation of creditors do not distinguish between secured and unsecured creditors.  Paras. 444; 458-459 note that some insolvency laws require secured creditors to surrender their security before they can participate in the proceedings and vote as a member of the creditor body. Where they are under-secured, however, their participation in the committee or in voting by the creditor body may be appropriate to the extent that they are under-secured. In reorganization proceedings, secured creditors will have an interest in negotiating with the debtor

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
			and other parties, particularly where their rights may be modified by a reorganization plan, or where the encumbered asset will be key to the successful implementation of the plan. Creditor committees generally represent only unsecured creditors. While some laws allow a separate committee of secured creditors, other laws provide for both types of creditors to be represented on the same committee. A further approach is for an insolvency law not to specify which creditors should be represented in a given case, but to allow creditors to collectively choose their own representatives on the basis of willingness to serve.
22. When can secured creditors vote?			<p>Rec. 111 provides that the law should specify the matters on which the vote of creditors is required and establish the relevant eligibility and voting requirements. In particular, creditors should vote to approve a reorganization plan.</p> <p>Para. 474 notes that some laws distinguish matters requiring the support of both secured and unsecured creditors; secured creditors will only participate in the vote on specified matters such as selection of the insolvency representative and matters affecting their security. See also Reorganization.</p>
	Party in interest's right to be heard	III.D	Rec. 121 provides that all parties in interest should have a right to be heard (no specific reference to secured creditors).
	Reorganization plan	IV.A	Rec. 128 provides that the law should specify the minimum contents of a plan, which may include ... means for the implementation of the plan which may include ... (v) [modification of terms of security interests, including] extension of a maturity date or a change in an interest rate or other term; [(vi) continued use of encumbered assets;] ...” (see also paras. 498-499).
23. How are secured creditors bound to a reorganization plan if they disagree with it or abstain from voting?			Paras. 512-517 discuss approaches to approval by secured and priority creditors. Para. 516 discusses the various approaches to binding dissenting members of a class of secured creditors which otherwise votes in support of a reorganization plan, and the protections that may apply or the conditions that must be satisfied before such creditors can be bound.
24. Should there be a minimum standard for the level of recovery by a secured creditor in reorganization proceedings?			<p>Para. 529 addresses the question of whether or not all classes of creditors must support the plan in order for it to be approved.</p> <p>Paras. 532-540 discuss mechanisms for binding dissenting creditors, in particular court confirmation of a plan approved by the requisite majority of creditors and the conditions that may apply to such confirmation.</p>
25. Must secured creditor consent to alteration of rights?			With regard to abstentions, para. 510 notes in passing that the insolvency law will need to address the manner in which non-participating or abstaining creditors will be treated. It notes, in particular, that some laws treat such creditors as voting to reject a plan, while other laws, for purposes of determining whether the majority required for approval has been met, only take into account those creditors actually voting.

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
			<p>The recommendations do not specifically refer to approval by secured creditors, but note the need for the insolvency law to specify (rec. 133) where voting takes place in classes, how the vote achieved in each class would be treated for purposes of approval of the plan and, where the approval of all classes is not required (rec. 134), that the law should address the treatment of those classes that do not vote in support of a plan that is otherwise approved by the requisite majority or the requisite classes.</p> <p>Rec. 136 provides that the plan should bind debtor, creditors and other interested parties either through approval by the requisite majority or through a combination of that approval and confirmation by the court.</p> <p>Rec. 137: “[The law may provide that if secured creditors do not support a plan and the encumbered assets are required for the reorganization, the court may order that the assets may continue to be used in the reorganization, subject to protection of the interests of the secured creditor.]”</p> <p>Where the law requires court confirmation of a plan approved by the requisite classes or majority of classes, rec. 138 sets out the conditions that should be met including: “(c) that the creditor will receive as least as much under the plan as they would have received in liquidation, unless they have agreed to lesser treatment; and (f) that the treatment of claims in the plan conforms to the ranking of claims under the law, except to the extent that affected creditors agree otherwise.”</p>
26. Can secured creditors vote on a reorganization plan?			<p>Paras. 510, 512-514 note that the voting of secured creditors depends upon the manner in which the insolvency regime treats secured creditors, the extent to which a reorganization plan can affect the security interest of the secured creditor, and the extent to which the value of encumbered assets will satisfy the secured creditor’s claim. It is noted that where the insolvency law does not affect secured creditors, secured creditors do not need a right to vote or protections but that a successful reorganization is unlikely. A secured creditor may vote to the extent its claim is unsecured.</p> <p>Para. 515 notes that different approaches to voting include voting as separate class on a plan that would impair secured claims, or each secured creditor forming a class of its own, since their interests very often differ from each other.</p> <p>Paras. 515, 529 note that requirements for voting of secured creditors are generally the same as for approval by unsecured creditors, although some laws require different majorities depending upon the manner in which secured creditors’ rights are to be affected by the plan and the need for their support of the plan.</p>

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
27. What happens if the plan is not approved?			The guide discusses modification of a proposed plan (para. 530); and conversion to liquidation (para. 531); rec. 145 provides for conversion by the court where, inter alia, “(c) a proposed plan is not approved”.
28. Once approved, can a plan be challenged?			<p>Rec. 138 sets forth the conditions which must exist in order for a plan to be confirmed by the court (where court confirmation is required); rec. 139 addresses challenge where no court confirmation is required; rec. 140 provides for challenge of a confirmed plan on the basis of fraud.</p> <p>Para. 535 discusses grounds for challenge available under different laws which may include that the plan is not feasible, e.g. secured assets are required for successful implementation of the plan, but secured creditors are not bound by the plan and no agreement has been reached with relevant secured creditors concerning enforcement of their security interests.</p>
29. Does the stay on secured creditors continue in the case of conversion to liquidation?			Para. 550 notes that an insolvency law needs to consider this issue.
	Expedited reorganization proceedings	IV.B	Inclusion of secured debt: para. 559 notes that secured debt can be included in voluntary restructuring negotiations with the agreement of the secured creditors.
30. Are secured creditors required to submit claims? What are the consequences of submitting a claim?	Treatment of creditor claims	V.A	<p>Rec. 156: “The law should specify whether secured creditors are required to submit claims” (footnote 104 to rec. 156 notes that under some laws a secured creditor who files a claim is deemed to have waived the security or some of the privileges attached to the credit, while under other laws failure to submit a claim has that result). See also paras. 567-569, 587.</p> <p>Paras. 586-589 discuss different approaches to failure to submit a claim and rec. 159 points to the need for an insolvency law to address the consequences of failure to submit a claim.</p> <p>Notification of need to submit: para. 570 suggests that where the claims procedure can affect the rights of a secured creditor, notification of the commencement of proceedings should include information regarding the submission, or failure to submit, secured claims: see rec. 19.</p> <p>Rec. 154 requires a creditor to submit a claim and establish the basis and amount of the claim; rec. 161 addresses evidence.</p>
31. What happens if the value of the encumbered asset is less than the secured claim?			Rec. 167: “[The law should provide that the insolvency representative may determine the portion of a secured creditor’s claim that is secured and the portion unsecured by valuing the encumbered asset.]”. (See also 9 above.)

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
			<p>Paras. 567-569 discuss different approaches including that a secured creditor may be required to submit a claim for any unsecured portion of its claim as an ordinary unsecured creditor. The value of the unsecured claim thus depends upon the value of the encumbered asset, the time at which that value is determined and the method of valuation used. Another approach requires secured creditors to submit a claim for the total value of their security interest irrespective of whether any part of the claim is undersecured, a requirement which in some laws is limited to the holders of certain types of security interest, such as floating charges, bills of sale, or security over chattels.</p>
<p>32. Can statutory priorities, in insolvency, amend the first priority of secured creditors?</p>	<p>Priorities and distribution [of proceeds of liquidation]</p>	<p>V.B</p>	<p>Paras. 624-626 discuss ranking of claims and note that many insolvency laws recognize the rights of secured creditors to have a first priority for satisfaction of their claims, either from the proceeds of sale of the specific encumbered assets or from general funds. Para. 625 notes, however, that some insolvency laws do not afford that first priority and discusses the different approaches taken, including those that rank payment of secured creditors after administration costs and other claims, or limit the amount that can be recovered (in priority) by secured creditors from the assets securing their claim to a certain percentage of that claim. Para. 626 notes that a further exception to the first priority rule may also relate to priorities provided in respect of post-commencement finance, where the effect on the interests of secured creditors of any priority granted should be clear at the time the finance is obtained, particularly since it may have been approved by the secured creditors (see also 14-16 above). It is further noted that such approaches may create uncertainty with respect to the recovery of secured credit and the guide suggests that limiting the use of such exceptions to first priority is highly desirable.</p> <p>Rec. 173: “The law should specify that secured claims should be satisfied from the security in liquidation or pursuant to a reorganization plan, subject to claims that are superior in priority to the secured claim, if any. Claims superior in priority to secured claims should be minimized and clearly set forth in the law. To the extent that the value of the security is insufficient to satisfy the secured creditor’s claim, the secured creditor may participate as an ordinary unsecured creditor.” See also rec. 172, 174.</p>
<p>33. Should there be a statutory reservation of a percentage of the value of encumbered assets for distribution to those other than the secured creditor?</p>			<p>Para. 625 (see 32 above). The paragraph also notes that some laws which do reserve a certain percentage for payment of lower-ranked creditors make a distinction between security interests over essentially all assets of a business (enterprise mortgage or floating charge) and other types of security interest.</p>

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
34. What is the treatment of subordination agreements in insolvency?			Paras. 617-623 discuss types of subordination; rec. 174 establishes ranking of claims, including deferred or subordinated claims. There is neither comparative discussion nor recommendations on the treatment of subordination agreements in insolvency.
35. Should secured creditors contribute to the costs of the administration of the insolvency?			Para. 626 notes that the secured creditor may be required to contribute to costs directly related to its interests, such as the administrative expenses related to the maintenance of the encumbered asset. If the insolvency representative has expended resources in maintaining the value of the secured asset, it may be reasonable to recover those expenses as administrative expenses from the amount that would otherwise be paid in priority to the secured creditor from the proceeds of the sale of the asset.
	Treatment of corporate groups in insolvency	V.C	Para. 651 notes that insolvency laws providing for consolidation of debts do not affect the rights of secured creditors, other than possibly the holders of intra-group securities (where the secured creditor is a group company).
	Applicable law governing in insolvency proceedings	V.D	<p>See A/CN.9/WG.V/WP.72.</p> <p>Rec. 179 provides that the insolvency law should recognize rights, entitlements and claims arising under general law, except to the extent of any express limitation and rec. 180 that the law applying to the validity and effectiveness of any right, entitlement or claim existing at the time of commencement of insolvency proceedings should be determined by the private international law rules of the jurisdiction in which insolvency proceedings are commenced.</p> <p>Rec. 181 provides that the law of the State in which insolvency proceedings are commenced should apply to all aspects of the conduct, administration and conclusion of those proceedings and their effects.</p> <p>Recs. 182-184 address exceptions to the application of the law of the insolvency proceedings: the effects of insolvency proceedings on the rights and obligations of participants in a payment or settlement system or in a regulated financial market should be governed by the law applicable to the system or market; rejection, continuation and modification of labour contracts and relations may be governed by the law applicable to the contract; and any additional exceptions should be limited in number and clearly set forth in the insolvency law.</p>
36. Treatment of title arrangements in insolvency	Title arrangements		The guide does not specifically address the treatment of title arrangements in insolvency, except to the extent that they may be covered by the discussion of security interests, treatment of third-party-owned assets and treatment of contracts. See generally paras. 162-164; 236-237; treatment of contracts II.E. Paras. 162-163 note that some insolvency laws permit assets in which the creditor retains legal title or ownership to be separated from the insolvency estate; and that under some laws separation of the asset may be subject to provisions on



Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
			<p>treatment of contracts. It is noted that the insolvency estate will generally include any rights that the debtor might have in respect of those assets (see issue 1). It is further noted that third-party assets may be crucial to reorganization or sale of the business in liquidation and that it will be desirable for the insolvency law to include a mechanism that will enable those assets to remain at the disposal of the insolvency proceedings, subject to protecting the interests of the third-party owner and the right of that party to dispute that treatment. Para. 236 also notes the possible need to use third-party-owned assets in reorganization and sale of the business in liquidation and that insolvency laws generally treat that issue in the context of constitution of the estate or the treatment of contracts, imposing restrictions on the termination of a contract or preventing the owner from reclaiming the assets for a limited period of time. Para. 237 discusses the need to protect against diminution of value of the assets.</p> <p>No specific reference is made to title arrangements in the chapter on treatment of contracts.</p>
37. Does stay extend to retention of title arrangements?			<p>It is intended that the stay would apply either (i) because the retention of title arrangement is treated as a security interest and rec. 34(b) applies to stay the “enforcement of security interests”, subject to the normal relief measures available (see rec. 38); or (ii) because the arrangement is treated as a contract where both parties have obligations to perform and rec. 34 (a) (stay on commencement or continuation of actions concerning the rights, obligations or liabilities of the debtor) or (d) (stay on termination of contracts) would apply.</p> <p><i>With respect to (ii), however, the Working Groups may wish to consider whether, as currently drafted, rec. 34 would be broad enough to include a prohibition on the recovery of, or interference with, property held or occupied by or in the possession of the debtor, which may not be a termination of the contract under rec. 34(d) or an action falling within rec. 34(a)?</i></p>
38. What power does the insolvency representative have to use or sell assets subject to retention of title arrangements?			<p>If treated as a security interest, the insolvency representative will have the same powers as apply in the case of an encumbered asset: recs. 40, 43, 44.</p> <p>If treated as a contract where both parties have obligations to perform, the insolvency representative may use the procedure governing continuation of a contract: recs. 58-71.</p>
39. Under what circumstances will the holder of a right of retention of title be bound by a reorg. plan?			<p>If treated as a security interest, the holder of a right of retention of title would be bound in the same manner as a secured creditor: rec. 137. If treated as a contract where both parties have obligations to perform, the outcome will depend upon treatment of the contract.</p>

Issue	Subject heading	Ref.	Basic Treatment in draft UNCITRAL Legislative Guide on Insolvency Law
40. What is the treatment of conditional sales in insolvency?			Not specifically addressed.
41. What is the treatment of financial leases in insolvency?			Not specifically addressed, although see para. 163.
42. Is “surplus value” part of the insolvency estate?			Not specifically addressed.
43. Does stay extend to lessor of property that is in possession or control of debtor?			See Insolvency Guide chapter II.B Application of the stay; discussion of use of third-party-owned assets (paras. 236-237) and the note to Working Groups in respect of issue 37.

**G. Note by the Secretariat on the draft legislative guide on insolvency law,  
working paper submitted to the Working Group on Insolvency Law  
at its thirtieth session**

**(A/CN.9/WG.V/WP.72) [Original: English]**

**Applicable law in insolvency proceedings**

1. At its twenty-ninth session in September 2003, Working Group V (Insolvency Law) discussed applicable law in insolvency proceedings on the basis of document A/CN.9/WG.V/WP.63/Add.17. The Secretariat was requested to reflect the discussion in revising the text of the recommendations on applicable law and to develop a commentary for consideration by the Working Group at its next session. The Secretariat was also requested to consult with the Hague Conference on Private International Law.

2. This note sets forth, for the consideration of the Working Group, a draft commentary on applicable law in insolvency proceedings and a set of revised recommendations developed in consultation with the Hague Conference on Private International Law. This material is intended to replace the existing section D following para. 652 of document A/CN.9/WG.V/WP.70 Part II (and would require appropriate renumbering of the commentary and recommendations of that document).

3. The Working Group may wish to consider the placement of the revised recommendation 179 in the Guide, on the basis that it does not address issues of applicable law (see also recommendation 74(a) in chapter II.F on avoidance).

**Part Two. Core provisions for an effective and efficient  
insolvency law**

**V. Management of proceedings**

**D. Applicable law in insolvency proceedings**

**1. Introduction**

652a. Where insolvency proceedings involve parties or assets located in different States, complex questions may arise as to the law that will apply to questions of validity and effectiveness of rights in those assets or of other claims; and to the treatment of those assets and of the rights and claims of those foreign parties in the insolvency proceedings. In the case of such insolvency proceedings, the forum State will usually apply its private international law rules (or conflict of laws rules) to determine which law is applicable to the validity and effectiveness of a right or claim and to their treatment in the insolvency proceedings. The UNCITRAL Model

Law on Cross-Border Insolvency (see chapter VII) does not include harmonized conflict of laws rules for adoption by enacting States, thus leaving these matters to established rules and practices. While insolvency proceedings may typically be governed by the law of the State in which those proceedings are commenced (the *lex fori concursus*), many States have adopted exceptions to the application of that law which vary both in number and scope. The diversity in the number and scope of these exceptions may create uncertainty and unpredictability for parties involved in cross-border insolvency proceedings. By specifically addressing, in a transparent and predictable manner, issues of applicable law an insolvency law can assist in providing certainty with respect to the effects of insolvency proceedings on the rights and claims of parties affected by those proceedings.

## 2. Law applicable to the creation of rights, entitlements and claims

652b. In a purely domestic setting, insolvency law does not “create” rights (personal or proprietary) or claims, but should respect the rights and claims that have been acquired against the debtor according to other applicable laws, that is civil, commercial, or public law. Insolvency law concerns itself with determining the relative position of each of those rights and claims once insolvency proceedings have commenced and, where appropriate, with establishing the restrictions and modifications to which they will be subject in insolvency proceedings in order to fulfil the collective aims of those proceedings. These limits and restrictions are “insolvency effects” because they arise from the commencement of insolvency proceedings against a debtor.

652c. In the context of cross-border insolvency, it is essential to distinguish between the creation of rights and claims under the law designated as applicable law (whether domestic or foreign substantive law) in accordance with the conflict of laws rules of the forum and the insolvency effects on those rights and claims. Since, as noted, the insolvency law does not establish rights or claims, the issue of whether a given right or claim has been created, and the content of that right or claim, belongs to the realm of general conflict of laws rules. It is typical under general conflict of laws rules, for example, that the law governing the contract will determine if a contractual claim exists against the insolvent debtor and the amount of that claim; that the *lex rei sitae* will determine if a security interest in immovable assets has been created in favour of a specific creditor, and so on. In this sphere, each State will apply its own conflict of laws rules, including any international conventions in force. In the case of an insolvency proceeding, the forum State will usually apply its conflict of laws rules to determine which law governs the validity and effectiveness of a right or claim before considering the treatment of the right or claim in the insolvency proceedings. It is important to stress that the determination of validity and effectiveness is not an insolvency question, but a matter of other applicable law.

## 3. Law applicable to insolvency effects—*lex fori concursus*

652d. Once a right or claim is determined to be valid and effective under the law designated as applicable by the conflict of laws rules of the forum, a second issue is the effect of insolvency proceedings on the right or claim—that is, whether it will be recognized and admitted in the insolvency proceedings and, if so, its relative position. This is an insolvency matter. From the conflict of laws point of view, the problem in this second phase lies in determining the law applicable to these

insolvency effects. It is quite typical that the law of the State in which insolvency proceedings are commenced, the *lex fori concursus*, will govern the commencement, conduct, administration and conclusion of those proceedings. This would generally include, for example, determining the debtors that may be subject to the insolvency law; the parties that may apply for commencement of insolvency proceedings and the eligibility tests to be met; the effects of commencement, including the scope of application of a stay; the organization of the administration of the estate; the powers and functions of the participants; rules on admissibility of claims; priority and ranking of claims; and rules on distribution. Accordingly, this law generally will govern the insolvency effects over rights and claims validly acquired under foreign law, for example, whether the right or claim, given its nature and conditions, is admissible in the insolvency of the debtor and how it will be ranked.

652e. Problems may arise when the law governing the ranking of a claim and the applicable law other than the insolvency law governing the claim are different. The categories of privileges and priorities that exist and the ranking of claims is always established by the *lex fori concursus*. Normally, when establishing these categories and ranking, the insolvency law of a State takes into account the existence of these claims under the domestic law of the State. However, the claim of a creditor may be constituted in accordance with a foreign law. In that case, it is necessary to determine which claims created under foreign law qualify as equivalent to domestic law claims conferring certain privileges or priorities. In other words, it is necessary to examine whether the kind of claim created under foreign law is “equivalent” to the kind of claim upon which the *lex fori concursus* confers a special status in insolvency proceedings. The test to apply is whether or not both claims, given their essential content and their function, correspond to each other to the extent that they can be considered as “functionally interchangeable”. If the answer is in the affirmative, the claims should be considered as equivalent and receive the same treatment in insolvency proceedings. In the event that equivalence cannot be established, the claim would generally be treated as an ordinary claim.

#### **4. Law applicable to insolvency effects—exceptions to the *lex fori concursus***

652f. To determine the insolvency effects on valid and effective rights and claims, some laws adopt exceptions to the application of the *lex fori concursus*. The purpose of the exception is not to change the law applicable to the question of validity and enforceability (which continues to be governed by the general conflict of laws rules of the forum), but to change the law applicable to the insolvency effects. Instead of applying the *lex fori concursus*, the insolvency effects may be governed, for example, by the same law applicable to the question of validity and effectiveness. For instance, the insolvency effects over a right to set-off may be determined not by the *lex fori concursus*, but by the law applicable to the right of set-off. Other examples of exceptions to the application of the law of the forum that have been adopted by different insolvency laws address the law applicable to payments systems, labour contracts, avoidance provisions, and proprietary rights.

##### **(a) Payment and settlement systems and regulated financial markets**

652g. Exceptions to the application of the *lex fori concursus* respond, in general, to certain social policy considerations. Some laws focus, for example, on supporting commercial certainty and reducing risk for the parties engaged in commercial

transactions. The parties to a transaction shape their relationships against the background of a specific legal environment, which includes consideration of the degree to which their rights will be protected in the event of the insolvency of the debtor, the most typical risk faced by any creditor. The application of the law under which the right or claim in question was created may be, in general, less costly for the creditor to learn, more predictable in terms of insolvency effects and more difficult for the debtor to manipulate ex-post than the application of the law of the debtor's centre of main interests or domicile. On that basis, it may be argued that it would be reasonable, under certain circumstances, to permit and protect reliance by the parties on the law under which the right or claim was created. A key example relates to payment or settlement systems and regulated financial markets, which many insolvency laws recognize as requiring an exception to the application of the *lex fori concursus*. By applying the law that is applicable to the system or the regulated market, alteration of the mechanisms for payment and settlement in the event of insolvency of a participant can be avoided, thus protecting general certainty and confidence in the system or market and avoiding systemic risk.

**(b) Labour contracts**

652h. Some laws adopt exceptions to preserve certain rights or interests specially protected by the law of a State from the uncertainties or inconsistencies that may result from the application of the insolvency effects of a foreign *lex fori concursus*. For example, with respect to labour contracts, special (often mandatory) protections may be afforded in terms of a financial safety net for workers, or restrictions on the rejection or modification of those contracts in insolvency. The rationale of such provisions lies in protecting the reasonable expectations of employees with respect to their contract of employment, recognizing that workers may have a relatively weaker bargaining position than their employers, and in ensuring non-discrimination amongst workers working in the same jurisdiction, whether they are employed by a local or by a foreign employer.

**(c) Security interests**

652i. Some insolvency laws also adopt this approach with respect to security interests. This solution means that the law governing a right *in rem* would determine not only its creation and general validity, but also its effectiveness in the case of insolvency proceedings. In other words, the position of the real security interest in insolvency proceedings commenced abroad will not be established by the *lex fori concursus*, but by the insolvency rules of the law applicable to the security interest. Application of the *lex fori concursus* otherwise may affect the legal framework for secured lending, introducing a factor of instability that may increase the domestic cost of finance. If foreign proceedings intrude upon local security interests, the value of those security interests may be seriously impaired. Similarly, a transfer of the debtor's centre of main interests to a different State can bring about a radical change in the position of the secured party. Rights of set-off may also be subject, as noted above, to law other than the law of the forum, for reasons related to the parties' expectations, especially if they engage in regular dealings with each other.

**(d) Avoidance provisions**

652j. The rationale of supporting certainty and diminishing risk may also apply to the application of avoidance provisions. Many insolvency laws provide that the law

governing the avoidance of transactions should be the *lex fori concursus*, even where, under the general conflict of laws rules of the forum, the transactions to be avoided would be governed by foreign law. Other laws look to the law governing the transaction to also govern avoidance actions relating to the transaction. The policy underlying these exceptions to the application of the *lex fori concursus* protects the counterparty and its reliance on the law governing the transaction. Such an approach may provide counterparties with some degree of certainty and predictability that their transaction with the debtor will not subsequently be subject to attack in insolvency proceedings and assist in reducing the cost of credit and commercial transactions because of the diminished risk of avoidance (which may be essential in the case of transactions taking place in a payment or settlement system).

652k. Some of the laws that look to the law governing the transaction for avoidance actions adopt an approach that combines both the *lex fori concursus* and the law governing the transaction in one of several ways. One approach provides that a transaction will not be subject to avoidance in insolvency unless it is avoidable both under the law of the State in which the insolvency proceedings commenced and the law governing the transaction. A second approach provides that a transaction can be avoided if avoidance can be achieved under either the law of the forum or the law governing the transaction. One law, for example, provides that the law of the forum will apply to avoidance, but recognizes the application of a different law where that different law is stricter than the law of the forum and would lead to avoidance of a wider range of transactions.

##### **5. Achieving a balance between the desirability of exceptions and the goals of insolvency**

652l. It is critical that policy considerations that form the basis of an exception to the application of the *lex fori concursus* be weighed against other considerations that are central to insolvency proceedings, in particular the goal of maximizing the value of the insolvency estate for the benefit of all creditors, rather than specific individual creditors, and treating all similarly-situated creditors equally. The law of the forum will be designed to support the specific goals of insolvency in that jurisdiction and will provide certainty for the insolvency representative in performing many of its functions with respect to the insolvency proceedings, including avoidance of transactions, treatment of contracts, treatment of claims and so on. Its application in insolvency proceedings may avoid potentially costly and extensive litigation to determine issues of applicable law for purposes of insolvency effects, and the validity and effectiveness of rights or claims given the insolvency effects under the law of the forum. Thus, in many circumstances the application of the *lex fori concursus* for insolvency effects may reduce costs and delays and therefore maximize the value of the insolvency estate for the benefit of all creditors. Furthermore, the application of an exception to the *lex fori concursus* for insolvency effects may result in disparate treatment of the insolvency effects on similarly-situated creditors merely because their rights and claims are governed by different applicable law. It may be argued, for example, that the rules of set-off of the forum should be applied to claims on the basis that, in insolvency, rights of set-off are closely related to the proof and quantification of claims and policies governing the equal treatment of creditors. Since these are questions regulated by the law of the forum, the rights of set-off should be similarly regulated.

## Recommendations

### Purpose of legislative provisions

The purpose of provisions on the applicable law in insolvency proceedings is to:

- (a) Facilitate commerce by recognizing, in insolvency proceedings, the rights and claims that arise before commencement of insolvency proceedings and the law that will apply to the validity and effectiveness of those rights and claims;
- (b) Establish the law applicable in insolvency proceedings and exceptions, if any, to the application of that law.

### Contents of legislative provisions

#### *Recognition of rights and claims arising before commencement*

(179) The insolvency law should recognize rights and claims arising under general law, except to the extent of any express limitation in the insolvency law.

#### *Law applicable to validity and effectiveness of rights and claims*

(180) The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings should be determined by the private international law rules of the State in which insolvency proceedings are commenced.

#### *Law applicable in insolvency proceedings*

(181) The insolvency law of the State in which insolvency proceedings are commenced (*lex fori concursus*) should apply to all aspects of the commencement, conduct, administration and conclusion of those insolvency proceedings and their effects. These may include, for example:

- (a) Identification of the debtors that may be subject to insolvency proceedings;
- (b) Determination of when insolvency proceedings can be commenced and the type of proceeding that can be commenced, the party that can apply for commencement and whether the commencement criteria should differ depending upon the party applying for commencement;
- (c) Constitution and scope of the insolvency estate;
- (d) Protection and preservation of the insolvency estate;
- (e) Use or disposal of assets;
- (f) Proposal, approval, confirmation and implementation of a plan of reorganization;
- (g) Avoidance of certain transactions;
- (h) Treatment of contracts;
- (i) Set-off;



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- (j) Treatment of secured creditors;
  - (k) Rights and obligations of the debtor;
  - (l) Duties and functions of the insolvency representative;
  - (m) Functions of the creditors and creditor committee;
  - (n) Treatment of claims;
  - (o) Ranking of claims;
  - (p) Costs and expenses relating to the insolvency proceedings;
  - (q) Distribution of proceeds;
  - (r) Conclusion of the proceedings; and
  - (s) Discharge.

*Exceptions to the application of the law of the insolvency proceedings*

(182) Notwithstanding recommendation (179), the effects of insolvency proceedings on the rights and obligations of the participants in a payment or settlement system or in a regulated financial market shall be governed solely by the law applicable to that system or market.

(183) Notwithstanding recommendation (179), the effects of insolvency proceedings on rejection, continuation and modification of labour contracts may be governed by the law applicable to the contract.

(184) Any exceptions additional to recommendations (182) and (183) should be limited in number and be clearly set forth or noted in the insolvency law.

**H. Report of Working Group V (Insolvency Law)  
and Working Group VI (Security Interests) on the work of their  
second joint session (New York, 26 and 29 March 2004)  
(A/CN.9/550) [Original: English]**

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**I. Introduction: Summary of the previous deliberations of the Working Groups**

1. At its thirty-fifth session (2002), the Commission noted with satisfaction the efforts undertaken by Working Groups V (Insolvency Law) and VI (Security Interests) towards coordinating their work on the treatment of security interests in insolvency proceedings and endorsed a suggestion that the two working groups proceed on the basis of commonly agreed principles (see A/CN.9/511, paras. 126-127 and A/CN.9/512, para. 88). At the session, the Commission also endorsed a suggestion for closer coordination of the work of the two working groups, including a suggestion to hold joint meetings.<sup>1</sup>

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<sup>1</sup> *Official Records of the General Assembly, Fifty-seventh Session, Supplement No. 17 (A/57/17), para. 203.*

2. At their first joint session (Vienna, 16-17 December 2002), Working Group V and Working Group VI considered the treatment of security rights in insolvency proceedings on the basis of chapter IX, Insolvency, of the draft Legislative Guide on Secured Transactions (A/CN.9/WG.VI/WP.6/Add.5). At that session, the Secretariat was requested to prepare a revised version of chapter IX, Insolvency (see A/CN.9/535, para. 8).

3. At its thirty-sixth session (2003), the Commission expressed its appreciation to Working Groups V and VI for the progress made during their first joint session on matters of common interest and noted with satisfaction the plans for further joint meetings of experts.<sup>2</sup>

4. At its fourth session (Vienna, 8-12 September 2003), Working Group VI considered the revised version of chapter IX (A/CN.9/WG.VI/WP.9/Add.6) and requested the Secretariat to prepare a further revision (see A/CN.9/543, para. 15). At that session, a number of issues relating to the treatment of security interests in the draft Legislative Guide on Insolvency Law were identified (see A/CN.9/543, paras. 79-83). In view of the Commission's request to Working Group V to complete its work on the draft Legislative Guide on Insolvency Law and refer it to the thirty-seventh session of the Commission in 2004 for finalization and adoption, a second joint session of the Working Groups was proposed to further consider the issues identified by Working Group VI.<sup>3</sup>

## II. Organization of the session

5. Working Groups V and VI, which were composed of all States members of the Commission, held their second joint session in New York on 26 and 29 March 2004. The session was attended by representatives of the following States members of the Working Group: Austria, Cameroon, Canada, China, Colombia, France, Germany, India, Italy, Japan, Mexico, Russian Federation, Singapore, Spain, Sudan, Sweden, Thailand, United Kingdom of Great Britain and Northern Ireland and United States of America.

6. The session was attended by observers from the following States: Argentina, Australia, Belarus, Belgium, Czech Republic, Denmark, Ghana, Holy See, Ireland, Madagascar, Mongolia, Netherlands, Nigeria, Oman, Philippines, Poland, Qatar, Republic of Korea, South Africa, Switzerland and Turkey.

7. The session was also attended by observers from the following international organizations: (a) organizations of the United Nations system: International Monetary Fund (IMF), World Bank, World Intellectual Property Organization (WIPO); (b) intergovernmental organizations: Asian Development Bank, European Bank for Reconstruction and Development (EBRD), International Association of Insolvency Regulators (IAIR); (c) non-governmental organizations: American Bar Association (ABA), American Bar Foundation (ABF), Centre for International Legal Studies (CILS), Commercial Finance Association, Groupe de réflexion sur l'insolvabilité (GRIP), International Bar Association (IBA), International Chamber

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<sup>2</sup> Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), para. 217.

<sup>3</sup> Ibid., para. 197.

of Commerce (ICC), INSOL International, International Insolvency Institute (III), International Law Institute, International Working Group on European Insolvency Law, Max Planck Institute of Foreign and Private International Law, European Law Students Association (ELSA) and Union Internationale des Avocats (UIA).

8. The Working Groups elected the following officers:

*Chairman:* Alexander R. Markus (Switzerland, in his personal capacity)

*Rapporteur:* Carlos Sánchez-Mejorada y Velasco (Mexico)

9. The Working Groups had before them a note by the Secretariat: “Treatment of security interests in the draft Legislative Guide on Insolvency Law” (A/CN.9/WG.V/WP.71); and the draft Legislative Guide on Insolvency Law (A/CN.9/WG.V/WP.70, parts I and II).

10. The Working Groups adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Consideration of the treatment of security interests in insolvency proceedings.
4. Other business.
5. Adoption of the report.

### **III. Summary of deliberations and decisions**

11. The Working Groups considered the treatment of security interests in the draft Legislative Guide on Insolvency Law (the “draft Guide”) on the basis of document A/CN.9/WG.V/WP.71, focusing on the issues set forth in paragraph 7 of that document. The deliberations and decisions of the Working Groups with respect to those issues are set forth below.

### **IV. Consideration of the treatment of security interests in insolvency proceedings**

#### **A. Application of the stay and avoidance provisions to the perfection of a security interest**

12. As a preliminary matter, it was observed that, while recommendation 34 of the draft Guide included a specific reference to perfection of security interests, there was no discussion of perfection in the commentary to the draft Guide and it was suggested that such a discussion could usefully be added. It was also observed that use of the term “perfection” might need to be reconsidered and a broader description such as that in square brackets in recommendation 34 (b) “actions to make security interests effective against third parties” or a description referring to “publicity requirements” adopted.

13. With respect to the desirability of including perfection within the scope of the stay, the view was expressed that if law other than the insolvency law permitted

perfection within certain specified time limits or grace periods (as referred to in footnote 35 to para. 189 of A/CN.9/WG.V/WP.70), those periods might need to be recognized by the insolvency law, permitting perfection of a security interest after the commencement of insolvency proceedings, but within the specified grace period. Where law other than the insolvency law did not include such grace periods, the stay applicable after commencement of insolvency proceedings would operate to prevent perfection. That approach was widely supported. In addition, it was observed that the question of whether an act of perfection in insolvency would make a security interest effective against third parties should be distinguished from the issue of whether or not perfection was permitted. Under one law, for example, a security interest perfected after commencement would be of no effect in liquidation, while it could be effective in reorganization. It was also observed that the effect in insolvency might depend upon what the act of perfection involved. Where, for example, perfection required registration, it might be permitted to occur after commencement of insolvency proceedings, but a different view might be taken of perfection which involved the secured creditor taking possession of an asset, thus reducing the assets available for the estate.

14. With respect to the application of avoidance provisions to perfection, it was generally agreed that such actions should be subject to avoidance in the same manner as other actions discussed in the chapter on avoidance in the draft Guide.

## **B. Determination of economic value of security interests (especially timing of valuation)**

15. It was proposed that the discussion of valuation in paragraphs 210-214 of the draft Guide should include a cross-reference to the chapter on filing and verification of claims, since early filing of secured claims would enable an early determination of the value of those claims, the extent to which they were secured claims and whether or not protection was required.

16. Concern was expressed that as currently drafted, recommendation 39 of the draft Guide did not provide a clear entitlement to protection of the economic value of the encumbered asset, but rather left the decision on provision of protection up to the discretion of the court. It was stressed that secured creditors needed to know how their interests would be affected by the commencement of insolvency proceedings and, accordingly, that those effects should be set forth clearly in the insolvency law. In particular, they should know that where the economic value of the encumbered asset was affected by the commencement of insolvency proceedings, they would be entitled to some form of protection of the value of that asset. It was also observed that recommendation 39 was limited to those situations where the value of the asset did not exceed the value of the security interest or, if the value eroded, the creditor was likely to become undersecured, but did not address situations where the creditor was oversecured. In the latter situation, it was suggested, creditors might also be entitled to protection, such as by payment of interest. In response, it was stressed that an insolvency law should carefully balance the different interests of the parties to the proceedings. Paying interest to an oversecured creditor, it was contended, might result in that creditor receiving, as a result of insolvency proceedings, an advantage additional to that provided by its security interest and could not be supported.

17. After discussion, it was agreed that, as a general principle, the draft Guide should specify that, upon application to the court, secured creditors should be entitled to protection of the value of the encumbered assets. In providing that protection, the court would have the discretion to choose among the most appropriate measures of protection provided under the insolvency law. It was further agreed that the notion of erosion of value should be limited to erosion caused by the insolvency proceedings, such as where the operation of the stay prevented the secured creditor from exercising its remedies to protect the value of an asset, or where the debtor's use of an asset in the proceedings led to diminution of its value.

### **C. Treatment of secured creditors in reorganization where they disagree with, or abstain from voting on, the reorganization plan**

18. A number of views were expressed with respect to the treatment of secured creditors in reorganization. In particular it was questioned whether, for example, recommendation 138 of the draft Guide was intended to apply to a dissenting member of a class of creditors which voted in support of a plan or to a dissenting class of secured creditors; whether secured creditors were required to vote on a plan that impaired their interests; whether secured creditors could be bound to a plan against their agreement; and how encumbered assets could continue to be used in reorganization. It was noted that the text of the draft Guide contained certain text in square brackets and indicated a number of issues still to be resolved by Working Group V. It was suggested that the discussion in that Working Group take into account the issues raised at the joint session.

### **D. Derogations from first priority of secured creditors**

19. The Working Groups generally approved the commentary and recommendations of the draft Guide as currently drafted.

### **E. Treatment of subordination agreements**

20. A number of questions were raised as to how such agreements would be treated in insolvency proceedings, particularly with respect to classification and priority of subordinated claims. It was observed that these issues could be quite complex and that, since national laws adopted different solutions, addressing them in the draft Guide in any detail would prove difficult. As a general principle, it was agreed that subordination agreements should be respected in insolvency proceedings, provided the parties were not agreeing to a priority higher than would otherwise be accorded under the applicable law, and that the general principle in insolvency of recognizing pre-commencement priorities would include priorities based upon a subordination agreement. As a point of clarification, it was suggested that recommendation 174 of the draft Guide should be limited in its operation to subordination of claims by the court and not apply to contractual subordination. It was also suggested that a third type of subordination, that which resulted from the operation of law, should be mentioned in the draft Guide.

## F. Treatment of title arrangements

21. The Working Groups noted that Working Group VI had not reached a final position on the issue of classification of retention of title arrangements, but that for the purposes of the draft Legislative Guide on Secured Transactions, a transfer of title for security purposes was to be treated as a security device. In response to suggestions that the question should be left open in the draft Legislative Guide on Insolvency Law, it was widely agreed that the issue of classification was not one to be resolved by the insolvency law. However, the insolvency law should detail how different types of arrangements would be treated in insolvency proceedings, so that it would be possible to determine, however classified, how a retention of title arrangement would be treated. It was observed that the draft Legislative Guide on Insolvency Law, as currently drafted, did indicate that treatment in a clear and concise matter, addressing constitution of the estate, application of the stay, whether or not different types of arrangements could be included in a reorganization plan, the requirements for continuation of contracts and so on, as indicated in A/CN.9/WG.V/WP.71. It was also noted that the provisions on applicable law set forth in A/CN.9/WG.V/WP.72 were relevant to any discussion of the treatment of title arrangements in insolvency, in that the law applicable to a priority conflict involving a secured creditor could not be different from the law applicable to a priority conflict involving a seller with a retention of title.

22. As a point of clarification, attention was drawn to paragraph 156 of the draft Guide and the definition of the insolvency estate, in addition to the material cited in response to issues 36-39 of A/CN.9/WG.V/WP.71. One proposal was that that definition could perhaps include a specific reference to retention of title arrangements to provide certainty, but after discussion it was agreed that such a reference was not required. It was noted that the terminology used in the insolvency guide, and in particular the word “asset”, might be broader than generally understood as it included property rights and interests, a point which might need to be emphasized in the draft Guide.

## **I. Report on the 5th UNCITRAL-INSOL Judicial Colloquium on Cross-Border Insolvency, 2003**

**(A/CN.9/554) [Original: English]**

1. This note contains a report of the discussion and conclusions reached at the 5th Multinational Judicial Colloquium on Cross-Border Insolvency organized on 21-23 September 2003 in Las Vegas, United States of America, by the United Nations Commission on International Trade Law and INSOL International.<sup>1</sup>

2. Over 32 judges and Government officials attended from 27 States, representing a broad range of practical experience and perspectives from diverse legal systems. The Colloquium heard a progress report on adoption of the Model Law and current international work on insolvency law including the UNCITRAL draft Legislative Guide on Insolvency Law, the World Bank Principles and Guidelines and the World Bank Global Judges Forum on Insolvency and Commercial Enforcement, and discussed the role of the court in reorganization, judicial capacity-building and the European Council Regulation on Insolvency Proceedings.

### **Conclusions**

3. Participants expressed the hope that the activity currently being undertaken by international organizations in insolvency law reform would lead to better insolvency laws and institutional frameworks in the future, as well as to wider adoption of the UNCITRAL Model Law. Participants also agreed on the benefits of promoting greater understanding and appreciation of the difficulties involved in insolvency matters, particularly those which have international implications, and the various progressive methods being developed for effectively and efficiently handling them, not only in terms of training the judiciary, legal counsel and court officials, but also in terms of facilitating coordination and cooperation between courts, judges and other participants in insolvency proceedings. Participants acknowledged the value of continuing dialogue on these issues and the valuable role to be played by the Colloquium in facilitating exchange of views and experience. It was proposed that the various international organizations involved in insolvency law reform, including UNCITRAL, could assist that process by making available relevant information and literature, preferably on the Internet. It should be noted that the 6th UNCITRAL/INSOL Judicial Colloquium is being organized to take place in Sydney, Australia, in March, 2005.

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<sup>1</sup> The full transcript of the session evaluating the judicial colloquium is available on the UNCITRAL web site, [www.uncitral.org](http://www.uncitral.org) under News and meetings/papers and programs from previous colloquia held in conjunction with the work of UNCITRAL/Insolvency/UNCITRAL/INSOL Fifth Multinational Judicial Colloquium, 2003.



**Progress reports**

4. The Colloquium heard a report on the progress of adoption of the Model Law, including those countries that had already enacted legislation and those that were actively considering adoption. It was noted that the question of reciprocity continued to be an issue for some countries and the advantages and disadvantages of including such a provision in enacting legislation were discussed. It was pointed out that in some countries local legal tradition had a strong influence on the issue. Nevertheless, there was agreement that a requirement to demonstrate reciprocity could complicate fast and easy cooperation among courts from different jurisdictions and in this way and in principle, such a requirement could contradict a key objective of the Model Law.

5. The Colloquium also heard about progress on the work of UNCITRAL on the draft Legislative Guide on Insolvency Law and the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems. It was noted that in July 2003, the Commission had approved in principle the policy settings of the draft guide, with final approval expected from the Commission in June 2004. Participants were informed that the World Bank Principles and Guidelines were currently subject to a process of review in order to incorporate clarifications and additions based on the lessons and experience of the World Bank's pilot programme of assessments, and on further consultation with the international community. It was also noted that the World Bank and UNCITRAL have been working closely to ensure consistency at the level of principles.

6. Lastly, a report on the Global Judges Forum on Insolvency and Commercial Enforcement held in May 2003 at Pepperdine University (Malibu, California, United States) and sponsored by the World Bank was given. The purpose of the Forum was to discuss the application of international standards and effective practices relating to commercial enforcement and insolvency and to assist the World Bank in gathering relevant information to develop strategies to meet the challenge of institutional capacity-building in the coming decade. More than 100 judges from 65 countries attended the forum.

**Role of the court in reorganization**

7. Judges from several different countries participated in a panel discussion on the different roles the court might play in reorganization. It was clear from the discussion that the tasks assigned to a court having jurisdiction in respect of reorganizations vary according to the policy choices made by the legislature in the State concerned. Those policy choices affected the degree of specialized knowledge required of judges who sat in those courts and a comparison showed that they were required to exercise considerably different levels of supervision. In some jurisdictions, judges were required to exercise predictive business judgement on the basis of expert evidence put before the court and to determine, for example, whether the form and content of a reorganization plan met certain statutory criteria, including whether the plan was feasible, both economically and from a business point of view. In other jurisdictions that matter was left to the judgement of the proposed administrator of the plan or to creditors, and judges were required to perform a supervisory function, checking on the form of proceedings and the process of ratification of the plan by creditors.

8. Participants agreed that the ability of the court to deal with questions of business judgement relied very much both on specialist judges and on the specialist bar that served those judges. It was noted that in many countries, in particular smaller and developing countries, appropriate infrastructure was not necessarily available. Often those countries could not afford, and in fact may not possess, the personnel available to work in that way, so that other approaches were required. It was also recognized that the need for different skills gave rise to different training requirements. The greater the need for evaluation of matters of business judgement, the greater the need for judicial understanding of the economics of viable business. Making a predictive assessment of the likely economic feasibility of a plan was entirely different from the traditional judicial role of determining whether action taken in the past by a particular person was within a range of options reasonably available under a general standard.

#### **Facilitating judicial capacity-building**

9. It was pointed out that the ability to deal with and cooperate in respect of a cross-border case required judges to perform an “extra” role over and above that which would be required in a purely domestic insolvency case—namely, that there be an understanding that the proceedings in the home jurisdiction were conducted with an appreciation of, and a harmonization to the greatest extent possible, with the proceeding in the foreign jurisdiction. As noted with respect to the role of the court in reorganization, the procedural and substantive law of one jurisdiction could well reflect policy considerations that were different from the policy considerations that governed the insolvency regime in another jurisdiction. To ensure the smooth conduct of cross-border cases, it was recognized that judges would find it increasingly necessary to be aware of the cultural background, economic considerations and historical setting in the other jurisdiction and to develop relevant skills in a variety of ways and on a continuing basis.

10. Participants identified a number of ways in which such skills could be developed, including through initial orientation programmes and ongoing refresher programmes; more informal but perhaps regularly held discussions and update-meetings amongst judges who would be assigned to insolvency cases; practice statements based on the experience gained in previous cases; ready access to relevant “literature” on the subject; and judicial exchange visits, which may be particularly useful when the jurisdictions involved had a significant commonality in approach.

11. With respect to the provision of information and relevant literature, it was suggested that the UNCITRAL web site could play a useful role, providing direct and indirect commentary on relevant topics and links to other sites such as those of INSOL, the World Bank, the International Bar Association (Committee J), the International Insolvency Institute and others. It was recognized that each of those organizations is attempting to provide some of the building blocks for an efficient and effective insolvency regime domestically and internationally.

12. There was a general appreciation amongst participants that the best training is that which is readily accepted and indeed sought out by those in need of it, on the basis of a full appreciation of the issues involved. To facilitate both the development of appropriate training programmes and their delivery, it was suggested that the judiciary could be surveyed as to their training needs and preferred methods of

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programme delivery, with information provided as to how judges in other jurisdictions have found training helpful. In addition to a better-trained judiciary, it was noted that a better-trained insolvency bar and insolvency practitioners were invaluable in dealing with cross-border cases on a timely and coordinated basis.

13. Participants also discussed means of achieving coordination and cooperation in cross-border cases, with a number of judges describing relevant cases and the results achieved. It was noted that while courts have traditionally cooperated with each other and there has always been some form of communication between judges in different jurisdictions, the manner in which that was conducted was no longer appropriate to the types of cases being encountered and the speed with which issues needed to be resolved. It was observed that some jurisdictions, because of their economic integration and the similarity of their legal systems, have had an extensive history over the past decade of cross-border cases involving judicial communication. Consequently, they have developed procedures for addressing relevant issues and, with greater experience, those procedures are likely to be accepted as “routine”. Examples of countries that have been involved in such procedures included Bermuda, Canada, Cayman Islands, Israel, Switzerland, the United Kingdom of Great Britain and Northern Ireland and the United States. One significant area of discussion related to the way in which judicial cooperation could be implemented and the associated legal and ethical issues to be confronted, such as the rights of the parties to be informed about and to participate in communication between judges, the need for consent to such communication and the rights of the parties in the event of disagreement. It was suggested that one lesson that could be drawn from the discussion was the need to consider whether the objective informed observer might conclude that the procedure adopted was reasonable and of assistance in all the circumstances of the case and did not disadvantage any legitimate interest of a party.

14. It was observed by a number of judges, however, that there were significant impediments to adoption of such procedures in civil law jurisdictions. In essence the concern was that such direct communications were not permitted but rather that inefficient and ineffective methods such as the use of letters rogatory still would have to be employed. A number of judges agreed that that was one of the significant compelling reasons for adoption of the UNCITRAL Model Law to permit and facilitate direct cooperation and communication between the courts. Other judges pointed to concerns arising from rules of court procedure that might prevent direct communication and cooperation between judges. It was widely agreed that there was considerable value in continuing the dialogue on those issues.

**J. Draft UNCITRAL Legislative Guide on Insolvency Law:  
 compilation of comments by international organizations  
 (A/CN.9/558 and A/CN.9/558/Add.1) [Original: English]**

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## **I. Introduction**

1. In preparation for the thirty-seventh session of the Commission, the text of the draft Legislative Guide on Insolvency Law, as approved in principle by the Commission at its thirty-sixth session in 2003 and by the Working Group in September 2003 was circulated to all governments and to interested international organizations for comment. The comments received as of 26 March 2004 that relate specifically to the content of the draft Guide are reproduced below.

## **II. Compilation of comments**

### **International organizations**

#### **European Commission**

#### **Directorate-General Justice and Home Affairs**

[Original: English]

**First**, the draft Guide says that it would be used as a reference for law making but it does not provide a single set of solutions. Instead, there is some attempt in the Recommendations presented at the end of each section to strike a balance between the different objectives of insolvency law—e.g. between universal proceedings and territorial proceedings, liquidation and re-organization, creditor-friendly and debtor-friendly regimes, secured and ordinary claims. As a result, such an approach seems to argue against any need for harmonization e.g. through a binding international instrument. Where the recommendations address specific issues of substantive insolvency law, it is possible that such legislative guidelines would constitute a pragmatic solution, given the difficulty in finding a common approach on matters that were developed in different ways by national judicial systems. However, where jurisdictional rules and conflict of law rules may apply to cross-border insolvencies, there is a need to ensure their compatibility between countries.

Therefore the draft Guide refers to existing instruments of private international law such as the UNCITRAL Model Law on Cross-Border Insolvency and the EC Regulation No 1346/2000 of 29 May 2000 on Insolvency Proceedings. In particular, the definitions of the centre of main interests of the debtor and of an establishment for the opening of proceedings are also mentioned in the draft Guide. However, there is some inconsistency between paragraph 99—“especially where the parties are from a foreign country, it should be made clear in the law which courts have jurisdiction for which functions”—and footnote No 8—“this recommendation is intended to indicate minimum and non-exclusive grounds for commencing insolvency proceedings. Other grounds, such as the presence of assets, are used in some jurisdictions”. We find no particular justification for the continued use of the assets criterion. This is not to say that one may not exist—but, if it does, it should be inserted in the Recommendation. If it does not, or if it is weak—see paragraph 98 which states: “the test of presence of assets may therefore raise multi-jurisdictional issues, including the possibility of multiple proceedings and questions of coordination and cooperation”—we are not clear what recommendation is being made.

**Second**, under Recommendation (18) on page 69, paragraph 583 on page 219 and Recommendation (158) on page 228 about formalities for submission of foreign claims, it is worth mentioning the specific provisions of Articles 40 to 42 of EC Regulation No 1346/2000 concerning the information of creditors.

Page 72, under paragraph 161 beginning “other insolvency laws provide that the security right is unaffected by insolvency proceedings and secured creditors may proceed to enforce their legal and contractual rights”, it should be highlighted that such a principle is provided in a cross-border context by Article 5 of EC Regulation No 1346/2000.

Page 73, under paragraph 166, it would be useful to make a reference to the solution adopted in the Regulation which relies on the principle of proceedings with universal scope, while retaining the possibility of opening secondary proceedings whose effects are limited to the territory of the Member State concerned. There is automatic recognition of foreign decisions and special rules for coordination between liquidators.

Paragraphs 324-325 and Recommendation (74) on page 136 about “Security interests”: it is worth mentioning the Hague Convention on the law applicable to

certain rights in respect of securities held with an intermediary, adopted on 13 December 2002, Article 8.

As to the consideration of priority claims, paragraph 632 on page 234 states that this issue may be of particular concern in transnational cases. Besides the reference to the UNCITRAL Model Law, it is possible to describe briefly the balanced approach followed by the European Union through Article 4.2 (i) of Regulation No 1346/2000 –i.e. the ranking of claims is determined by the law of the State of the opening of (main or secondary) proceedings.

Turning to the crucial issue of group insolvencies, Section C on pages 238-241 favours an extensive approach of insolvency including groups of companies, while highlighting the disadvantages of such an approach. In the European Union, both the “companies group” approach (based on economic criteria) and the “incorporation” approach (based on the head office jurisdiction) were represented. Basically, the new Regulation does not provide for “consolidated” treatment of group companies. However, there are some contradictory cases by national courts that show the difficulty of applying common criteria in practice.

### **European Bank for Reconstruction and Development<sup>1</sup>**

[Original: English]

#### **General comments**

In submitting the comments included below, the EBRD noted the importance of insolvency for the transition economies of eastern Europe and Central Asia and that as part of its continuing work in this area, the EBRD will be conducting its New Legal Indicator Survey (NLIS) this year in the area of insolvency. The NLIS will involve measuring the practical effectiveness of the insolvency law regimes in the EBRD’s countries of operations to assist in determining where the main strengths and weaknesses of insolvency law regimes in those countries lie. The EBRD also noted the complementary nature of the work of EBRD and UNCITRAL, with the Bank’s main emphasis being on the economic benefits to be derived from the enactment of effective, efficient and transparent insolvency law regimes. Based upon their review of the Guide, they expressed that view that it furthers these goals and provides clear policy recommendations that will be of use to civil and common law countries with developed or developing economies.

#### **Specific comments**

Paragraph 126 provides that there is no general consensus as to whether re-organisation proceedings can be initiated by a creditor as well as a debtor. We are of the view that the ability of a creditor to initiate such proceedings is critical. This is not simply because management of the debtor corporation may have resigned but, also, because of the inherent desire that creditors are likely to feel to exert some control over the insolvency process. As you point out, in most regimes creditors may institute liquidation proceedings. If instituting restructuring proceedings is also an option to creditors, in other words if they can effect restructuring while still

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<sup>1</sup> The comments provided are noted as not having been reviewed by the EBRD’s management.

“driving” the process, we are of the view that creditors are more likely to support reorganisation. This is particularly true in the case of regimes in which the party commencing the proceeding is likely to be able to select the insolvency administrator. Creditors are far more likely to support a reorganisation if they are able to ensure that “their” insolvency administrator is at the helm.

Paragraph 142 speaks to the issue of notice to be given upon an application to commence proceedings. It is suggested in the guide that, in some circumstances, the debtor may not need to give notice of the application to commence proceedings to creditors. While there may be circumstances where this is appropriate, this has to be balanced with concerns arising from some insolvency regimes which allow the costs of the insolvency administrator to be put ahead of the interests of secured creditors. Where the law has such provisions, we are of the view that secured creditors should be entitled to notice of applications made to commence proceedings and that, if no such notice is provided, the costs of the insolvency administrator cannot be placed ahead of the interest of such creditors. If notice provisions are not practical in a specific legal regime, we would suggest a provision mandating that court orders initiating the insolvency process be served upon all secured creditors by the insolvency administrator, within a reasonable period of time, and that such secured creditors be explicitly authorised to apply for a variation of the cost provisions of these orders.

Paragraph 143 deals with notice to be given by creditors to the debtor when commencing proceedings but is silent on what notice, if any, need be given by creditors to other creditors. It is not clear whether this omission is intentional. For the reasons described in the preceding paragraph, other than when exceptional time-driven circumstances make it impractical, notice should be given to all known secured creditors by other creditors seeking to commence an insolvency proceeding.

Paragraph 324 suggests that security granted to secured creditors that is not in consideration of “new funds being advanced” may be avoidable under insolvency legislation. The presumption here is that where there are “new funds” advanced, the transaction will not be avoidable. We suggest that the Working Group may wish to amplify this point to be clear that it is not just the advancement of “new funds” that will protect the transaction but, rather, the advancement of any new consideration under the relevant legal system. This distinction is important in the context of, for example, lender forbearance arrangements. Where a lender agrees to forbear from enforcing its rights under a given loan agreement, such forbearance under many legal systems may be a valid consideration and should thus protect any new security given in exchange for that forbearance. As a result, while new cash may not be injected by the lender, valid consideration for new security has been provided.

Paragraph 402 suggests that the insolvency law should specify the degree of relationship between the debtor and the insolvency administrator which may give rise to conflicts of interest. We wholeheartedly endorse this position as such provisions promote greater transparency in the insolvency process. We suggest that the Working Group may wish to give consideration to going much further than this and recommending an outright prohibition against certain relationships. For example, where the insolvency administrator (often a public accounting firm) has, in the past, been the auditor of the debtor corporation, it may be inappropriate to have them act as insolvency administrator. Such proximate relationship poses numerous potential conflicts including, but not limited to, the obvious “Enron Situation”

where prior accounting practices of the company and its auditor in fact precipitated the debtor's insolvency. In this situation, an independent insolvency administrator may have the responsibility of pursuing those responsible on behalf of the creditors and would obviously be in conflict if the responsible parties included its own firm.

### **International Labour Organization (ILO)**

[Original: English]

The International Labour Office has followed with interest the work of UNCITRAL's Working Group V on insolvency law and wishes to present the following comments on Doc. A/CN.9/WG.V/WP.70(Part I) and Doc. A/CN.9/WG.V/WP.70 (Part II) in view of the forthcoming finalization and adoption of the Legislative Guide on Insolvency Law.

Concerning the key objectives of an effective and efficient insolvency law as listed in Part One of the Legislative Guide, the ILO cannot agree with the formulation of key objective No. 8 in para.21 (page 14) of the draft text, which declares that "to the greatest extent possible, those priorities should be based upon commercial bargains and not reflect social and political concerns that have the potential to distort the outcome of insolvency" and accordingly suggests that "priority to claims that are not based on commercial bargains should be avoided". In the ILO's view, this is an ideologically biased manner to express the objective of establishing clear rules for ranking of priority claims. It clearly advocates for priority to be given to money lenders or institutional creditors, thus prejudicing essentially workers whose work is, however, indispensable for any enterprise to be credit-worthy.

Money lenders charge interest on the loans they accord to debtors, in which the risk factor is implied. The risk of not being paid for a loan is normally a business risk for any money lender. As a matter of fact, money lenders charge different rates of interest, depending on the different level of risk each client represents for them. If despite the risk they accept the business, they should be expected also to accept the losses when their client becomes insolvent. By contrast, it is a basic principle in labour law that the workers do not share the employer's business risk. It follows that the approach adopted in the draft legislative guide means no less and no more than to shift the business risk of money lenders and contractors onto the workers' shoulders. Despite what might be the opinion of the drafters of the Guide, the fact remains that most countries in the world have taken the decision to privilege workers' claims in the event of the insolvency of their employer. As 95 countries are to date parties to the ILO's Protection of Wages Convention, 1949 (No. 95), Article 11 of which requires Members to treat workers as privileged creditors in the event of judicial liquidation or bankruptcy, the ILO feels that these countries cannot go along with UNCITRAL's proposal unless they repudiate the international obligations by which they are bound.

With regard to Part Two of the Legislative Guide dealing with core provisions for an effective and efficient insolvency law, the ILO objects to the position taken in para. 629 to the effect that "some priorities are based on social concerns that may more readily be addressed by other law, such as social welfare legislation, than by designing an insolvency law to achieve social objectives which are only indirectly related to questions of debt and insolvency" since "providing a priority in the insolvency law may at best afford an incomplete and inadequate remedy for the social problem, while at the same time rendering the insolvency process less effective". The danger is that, in the interest of facilitating the viability of an insolvent business and rendering the insolvency process less cumbersome for secured creditors and insolvency professionals, the guide not only pays



little attention to the social parameters of insolvency and liquidation but openly suggests that any consideration concerning the social protection of workers in the event of an employer's insolvency should be kept outside the ambit of insolvency law. The ILO has serious doubts as to the soundness of the view reflected in the draft Guide to the effect that insolvency law should not seek to respond to social concerns. The Guide in its current reading gives the disquieting impression that the real intention is to dismantle the system of privileged protection in respect of workers' claims, despite its nearly universal application, in order to better protect the interests of institutional creditors. All the more so as the Guide does not appear to propose a valid and readily applicable alternative to the privilege system, since the wage guarantee institutions, which are summarily referred to in the Guide, are admittedly "rich-country arrangements" and are very difficult to put in place and operate in the developing world.

In addition, the ILO considers that paras. 633 and 634 (page 235) reflect poorly international state practice, which overwhelmingly recognizes the need for special protection to be afforded to employee claims and grants such claims a ranking of priority higher than most other privileged claims. It is indicative that the draft text does not mention the case of those jurisdictions in which workers' claims enjoy a "super-privilege" ranking ahead of all other claims, including secured claims (in this connection, the definition of the term "superpriority" in the introductory part of the Guide is incorrect and has to be reworded). The ILO has had the opportunity to submit alternative language with respect to these two paragraphs which described more faithfully the state of law and practice in most countries, but none of its suggested wording seems to have been retained. The ILO wishes to make a new reference to the 2003 General Survey on the Application of the Protection of Wages Convention, 1949 (No. 95) prepared by the ILO Committee of Experts on the Application of Conventions and Recommendations, which contains in paras. 298-353 a lengthy analysis of national laws in matters of protection of employees' service-related claims. [copy forwarded with comments]

Moreover, recommendation 174 (page 238) as it is currently drafted seems to imply that workers' claims are to be grouped together with all other privileged claims in a single class of priority claims and that they may be satisfied proportionately (and not fully) in the event of insufficient assets. This view reflects the practice in a limited number of countries of common law tradition but is far from being widely accepted. In fact, in the great majority of countries, workers' claims constitute a class of privileged claims on their own and are granted a higher rank of priority than that of the State and the social security system. Besides, this prevailing view has found expression in Article 8(1) of the ILO's Protection of Workers' Claims (Employer's Insolvency) Convention, 1992 (No. 173), which requires Member States to accord to workers' claims a higher rank of privilege than most other privileged claims, and in particular those of the State and the social security system.

Overall, the ILO believes that the ongoing work of UNCITRAL's Working Group V on insolvency law is extremely relevant to its own Decent Work Agenda, indeed in certain respects directly challenging the policy objectives and priorities of the Organization. The ILO intends to keep a watchful eye on the discussions of the Working Group so as to ensure that basic concepts and principles of existing ILO instruments in the field of bankruptcy/ insolvency law are not uncritically undermined. As the ILO Committee of Experts has stated in para. 505 (p. 298) of the above-mentioned General Survey, "the process of making insolvency laws more effective should in no event result in such laws becoming socially insensitive. The designation of employees' wages and entitlements as a preferential debt is a keystone of labour legislation in practically every nation and the Committee would firmly advise against any attempt to question such a principle without proposing in its place an equally protective arrangement, such as a wage guarantee fund or

an insurance scheme providing a separate source of assets to ensure the settlement of employees' claims".

## International Monetary Fund Legal Department

[Original: English]

### 1. Overview

The IMF Legal Department has some remaining comments on key aspects of the Guide's discussion of reorganization issues, as well as on other sections of the Guide. This note first addresses reorganization, then provides comments on other chapters in the order that they appear in the Guide.

### 2. Reorganization proceedings

As noted in previous comments, our primary concerns relate to the provisions governing creditor voting on and approval of reorganization plans. It should be emphasized that these comments are not intended to change the policy direction of the Guide but, rather, are intended to address ways in which the Guide could be more specific and analytical about the policy choices in this critical area.

First, the Commentary and Recommendations need to state explicitly that, if the rights of secured creditors or other priority creditors can be affected by a reorganization plan, then these creditors must in all cases vote in a separate classes from unsecured creditors and from each other. As currently drafted, the Guide does not preclude applicability of a plan to priority creditors, but it also does not expressly state that such creditors must in all cases vote in separate classes. As such, the Guide could be read as allowing arrangements under which secured and other priority creditors may be forced to vote with unsecured creditors. This in turn could cause significant dilution – if not outright deprivation – of the rights of priority creditors and consequential effects, inter alia, on the availability, cost and other terms of credit in jurisdictions with such arrangements. To address this concern, language regarding the need for secured and priority creditors to vote in all cases in separate classes could be added to Rec. 130 and 133, as well as to the third sentence of para. 515 of the Commentary.<sup>2</sup>

Second, the Guide needs to clarify and discuss more systematically the minimum protections that a law should provide to dissenting creditors that are subjected to a restructuring plan (including both minority members of an approving class, and members of a rejecting class on whom the plan is being "crammed down"). The Commentary mentions in passing various kinds of protections (minimum liquidation value rule, absolute priority rule, etc.), but there is no systematic discussion of the issue and no clarification of the minimum protections that must be observed vis-à-vis dissenting creditors in order for a plan to be acceptable. To the contrary, the existing discussions seem limited and discontinuous.<sup>3</sup>

<sup>2</sup> Para. 515 could be revised to read as follows (additions underlined): "Adopting an approach that allows for secured and priority creditors to vote as a separate class provides a minimum safeguard for the adequate protection of such creditors, and recognizes that the respective rights and interests of secured and priority creditors differ from those of unsecured creditors."

<sup>3</sup> For example, para. 508 first sentence states only that there "may be a need" to ensure protection of dissenting creditors; and para. 532 states only that laws with cram down provisions

Third, while the issue is discussed well in the Commentary, the Recommendations do not seem to address the approach of subdividing unsecured creditors into classes for voting purposes.<sup>4</sup> As discussed in the Commentary, despite its potential complexity, subdividing of unsecured creditors can in some cases be a crucial means of assuring creditor approval of a reorganization plan. Accordingly, the Recommendations could very usefully be revised to specify that the law should also provide the option for subdividing unsecured creditors into further classes.

Fourth, beyond the voting and plan approval issues discussed above, a separate concern on the reorganization chapter relates to the discussion (para. 535 and 538) of the court's ability to reject or fail to confirm a plan on grounds of lack of economic "feasibility". The one example of such feasibility given in these paragraphs (i.e., lack of arrangements for dealing with secured claims) is appropriate, but the general feasibility point is much broader and could be used to reject a plan in many other, less appropriate, circumstances. Given the complexity of these kinds of economic decisions and the fact that creditors ultimately are the ones best placed to make them, we are of the view that laws generally should either not give courts power to reject a creditor-approved plan on feasibility grounds, or should define very narrowly the circumstances under which this power may be exercised. Language to this effect could usefully be added not only to the Commentary (e.g., para. 539), but also to the Recommendations.

Other comments on reorganization:

- To avoid unlimited court discretion (and, inter alia, the extensive delays that oftentimes go with it), Recommendations 123 and 125 should clarify the circumstances under which the plan filing period and exclusivity period may be extended, or at least should state that the law should identify specific and limited grounds on which such extensions can be granted.
- We would delete the brackets—and retain without revision the relevant statements—in Rec. 128(b)(i), 128(c)(v)-(vii), and 138(e) and (f).
- The references to recommendations "142" and "144" in Rec. 139(a) and 139(b), respectively, should probably read instead recommendations 138 and 140.
- Concerning expedited reorganization proceedings, the bracketed material in Recommendation 146(b) could very usefully be deleted, as such vote solicitation procedures are not likely to be well developed in many emerging markets.

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"generally" include conditions aimed at protecting creditors (with neither discussion shedding light on what are provisions are appropriate in what circumstances). Similarly, Rec. 134 simply notes that the law should address "the treatment" of dissenting classes where approval by all classes is not necessary; Rec. 137 provides for broad continued use of encumbered assets against the secured creditor's wishes without discussing specific protections; and Rec. 138 does not explain what constitutes "fair and equitable" treatment of creditors for plan confirmation purposes (notwithstanding that very few readers outside of the U.S. are likely to be aware of the "gloss" associated with this term under U.S. law).

<sup>4</sup> The current language (Rec. 130) states only that the law should address "whether or not creditors should vote in classes according to their respective rights"; this does not seem to contemplate subdividing *unsecured* creditors into further classes.

- The significance is unclear of the requirement in Rec. 150 that notice of the commencement of expedited proceedings be given to creditors “individually.” We would note, however, that expedited proceedings are increasingly being used not only with respect to banks and other easily identifiable creditors, but also to enable reorganizations involving debt held by bondholders. As such, it is important that the expedited proceedings not require individual notice by the insolvency representative to such widely dispersed creditors, but rather allow notice through the trustee or other arrangement contemplated under the terms of the bonds.
- In Recommendation 153, the first bracketed clause seems more appropriate, as it would simply allow reversion to original rights in the event of failure of an expedited plan. The second bracketed clause, calling for conversion to liquidation upon failure to implement a confirmed expedited plan, may have the effect of discouraging debtors from using expedited proceedings in the first place, thereby possibly delaying the stage at which debtors begin to address their financial difficulties.

### 3. Glossary

We continue to have the following concerns on the Glossary, which were noted in earlier comments on the Guide:

References to “Court”—Glossary para. 5 should include a nuance to the effect that alternatives to court involvement may be an option, *if such an alternative is permissible under the legal system of a country*. The point is that there are often *constitutional* limits under most legal systems on the extent to which the courts may be avoided entirely and replaced with administrative mechanisms. Consequently, even where administrative agencies are used, parties in these countries always retain a right ultimately to have their disputes heard by a *court*.

“Protection of the Value of Encumbered Assets”—This definition could very usefully be deleted, in light of the complexity of the subject; the alternative approaches possible (including protecting the value of a secured claim), which are not discussed in the Glossary; and the more detailed and clear discussion of the issue in Part II of the Guide.

“Secured debt”—The first bracketed definition (aggregate amount of secured claims) is more appropriate than the second (claims pertaining to secured creditors), although neither definition is entirely clear. The main point, recognized elsewhere in the Guide (and the contrary of what is stated in the second definition), is that the extent to which a claim is secured should depend on the *lesser* of the value of the secured creditors’ claim or the value of the collateral security. It would thus be useful to clarify in the Glossary that a secured creditor’s claim should be considered “secured debt” only up to the value of the collateral, as any other approach would give such a creditor a larger benefit than it has bargained for.

“Security interest”—The first sentence of the definition is not accurate, and could usefully be deleted. First (and as noted in the second sentence), a security interest need not be granted by a party, it can also be established involuntarily. Second, a security interest in itself does not “commit” a debtor to pay or perform its obligation; the commitment to pay/perform is established *in the underlying contract*,

and the security interest simply gives the creditor certain rights in the event of non-fulfillment by a debtor of its obligation to pay/perform.

“Stay of proceedings”—In addition to actions concerning the debtor’s rights, obligations and liabilities, it would seem that this definition should also cover *actions against the debtor*.

“Unsecured creditor”—Related to the comment under “secured debt” above, this definition could usefully clarify that unsecured creditor can include an otherwise secured creditor, to the extent that the value of its claim exceeds the value of the collateral.

#### 4. Institutional framework

Related to the comment above concerning the definition of “court”, para. 75 should clarify that even if the insolvency representative or other third party is given broad responsibility as a means of limiting the court’s role, court involvement would still be necessary under most legal systems *once there is disagreement regarding a matter assigned to the insolvency representative*. This in turn further demonstrates the necessity of strengthening judicial capacity in jurisdictions where such capacity is weak. The current discussion could be misread to give the impression that courts can be avoided (and thus that capacity building can be postponed), which is not correct.

#### 5. Assets constituting the insolvency estate

While we realize that the issue is discussed in greater detail elsewhere in the Guide, this section (in particular para. 160) could make clearer the point that adequate protection will need to be provided in all cases where encumbered assets are included in the estate. For example, the first sentence of para. 160 could note that where encumbered assets are included, they *should* (not just “may”) be subject to certain protections. The last sentence of the paragraph should similarly add the point that an insolvency law *should specifically ensure the protection of the property rights of secured creditors in encumbered assets*.

The Commentary (para. 173) appropriately notes that there are differences among jurisdictions as to whether the time of constitution of the estate is set by reference to the date of commencement, application or some other event. However, the “purposes” clause of this section needs to be revised to reflect these alternatives, as the current draft refers only to assets included in the estate on *commencement* of proceedings).

#### 6. Protection and preservation of the insolvency estate

This section concludes that an exception from the stay is appropriate where this is necessary to preserve a claim against the debtor (e.g., Rec. 35 and para. 182, 184). We do not disagree with the substance, but query whether the same result could not be achieved, without the complexity of an exception, simply by defining the stay so as to “toll” the running of the statute of limitations with respect to claims against the debtor. If there is no running of the statute of limitations, then a creditor’s rights to bring a claim against the debtor should be the same on the day the stay is lifted as it was on the day the stay became effective. If tolling of the statute of limitations is in fact already included under the Guide’s current concept of the stay, then the more

general question is why an exception to “preserve a claim” against the debtor is necessary.

In discussing the technique of protecting the value of the secured portion of the claim, para. 215 could very usefully note that this approach involves far less complexities than the alternative approach of protecting the value of the encumbered asset, particularly since the former approach eliminates the need for the complex and ongoing valuation judgments associated with the latter. Indeed, while discussed very little in the Guide, this approach may well be the most appropriate one for most emerging market jurisdictions that lack the institutional framework necessary for ongoing complicated calculations of collateral value.

Other comments on preserving the estate:

- The bracketed clause in Rec. 38(b) should probably be deleted, as this concept would further complicate the determination by raising additional valuation issues.
- As parties other than the debtor can also be affected by an order for provisional measures, para. 199 should discuss notice requirements for *interested parties generally* (and not only for the debtor).
- A subheading (“(ii) *Liquidation*”) seems to be missing immediately before the discussion beginning in para. 188.

#### 7. Use and disposal of assets

Para. 237 indicates that any “benefits” conferred on the estate by the continued use of third party assets should be paid for by the estate as an administrative expense. Rather than the narrow and subjective focus on “benefits” to the estate, it would seem that *all* claims due to a third party for the continued use of its assets should be to treat as an administrative expense. Para. 237 could usefully be revised to include the latter concept.

In the last sentence in para. 220, the phrase “In particular” should probably be replaced with “*For example*”.

#### 8. Treatment of Contracts

The current discussion of ipso facto clauses focuses exclusively on ipso facto *termination* clauses. The Guide could also usefully address the approach among jurisdictions towards the nullification or acceptance of other kinds of ipso facto clauses (e.g., clauses calling for penalty interest and other special charges upon insolvency or certain other events indicative of insolvency).

Similar to the point made above under use and disposal of assets, the reference in para. 270 to treatment as an administrative expense of “benefits received” under a subsequently rejected contract should be revised to note instead that administrative expense treatment will be provided for any *payments falling due* in connection with such contracts in the period until they are rejected.

We agree fully that claims relating to the rejection of a long-term contract may be limited by the law (Rec. 68). The Commentary, however, seems to discuss this only as an issue for long-term *leases* (para. 285) and needs to be expanded in this regard. More generally, it would seem that the overall discussion of damages for rejection

(para. 281, 282) could very usefully be expanded to sanction leeway for the law to limit damages in appropriate circumstances (e.g., not only for long-term contracts, but also in cases where the imposition of penalty interest and other kinds of default-related charges results in a much larger claim against the debtor than the original claim before calculation of these charges). The current statement that calculation of damages might be determined in accordance with applicable general law is not adequate, as it is unlikely that the general law will limit otherwise permissible damages simply to avoid overwhelming the claims of other creditors in an insolvency.

#### 9. Avoidance proceedings

It remains unclear why “potential creditors” are included in the definition of “transactions intended to defeat, delay or hinder the ability of creditors to collect claims” (Rec. 73 and para. 314), particularly given that a key reason for avoidance provisions is to overturn transactions that upset the principle of equitable treatment of *actual creditors*. Notably, this seems to be the only category of avoidable transactions that is defined by reference to a group other than actual creditors. It would be useful to clarify in the Guide the basis for this special rule (as well as perhaps to note that the problems of proof noted in the Guide are likely to be exacerbated where the finding relates to intent vis-à-vis a “potential creditor”). If there is no particular basis for the language regarding potential creditors, then this language should probably be deleted to avoid confusion.

The category of transactions that may be used as a defense to avoidance (Rec. 82) seems unduly limited, as it does not include (a) transactions entered into pursuant to voluntary workout or even expedited reorganization proceedings, or (b) transactions entered into pursuant to reorganization (or expedited reorganization) proceedings that are not subsequently converted to liquidation.<sup>5</sup> These transactions could very usefully be included among those that constitute a defense to avoidance (or an explanation added as to why such inclusion would not be appropriate).

Finally, we would delete the brackets (and retain the relevant sentence) in Rec. 81.

#### 10. The Participants

To avoid the inference that all insolvency representatives have such a role, the brackets in Rec. 95(c) could be removed and the currently bracketed phrase revised to read “where an insolvency representative is appointed *for such purposes*. . .”

#### 11. Treatment of Creditor Claims

A key premise of this section, namely, that claims excluded from the insolvency proceedings are legally uncollectible (see, in particular, para. 571), is not necessarily correct. Rather, in a number of insolvency laws, recovery of certain claims that are not provable within the insolvency proceeding (e.g., secured claims or government tax claims) can be pursued outside and in parallel with the insolvency proceeding. As such, the discussion could very usefully distinguish

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<sup>5</sup> For its part, the Commentary (para. 329) identifies, as an avoidance defence, payments under both expedited reorganization proceedings or voluntary restructuring agreements, but it still limits the defence to cases in which liquidation proceedings are subsequently commenced.

between the alternative effects of: (i) extinguishing claims that are excluded from insolvency proceedings; and (ii) preserving alternative recourse for claims that are excluded from insolvency proceedings. For similar reasons, the discussion on failure to submit claims should explicitly state that it is dealing with the consequences of failure to submit claims that are required to be submitted in insolvency, and not dealing with those claims that can or must be enforced outside of insolvency.

## 12. Priorities and Distribution

In para. 631, we found curious the reference to the “need to give effect to international obligations” as a relevant consideration for according privileged status to debt owed by corporate or individual debtors. It would be very useful to explain the motivation behind this provision, particularly since the reference may otherwise be read as relating to international obligations of *sovereign debtors* (thereby leading to a misunderstanding that the Guide also provides guidance for sovereign insolvency issues).

## 13. Discharge

The Commentary discusses discharge of legal persons in reorganization proceedings, but this is not addressed in the Recommendations. This important issue should be dealt with in the Recommendations.

A/CN.9/558/Add.1

### **Draft UNCITRAL Legislative Guide on Insolvency Law: compilation of comments by international organizations**

#### ADDENDUM

#### **Spain**

#### **Comments submitted by Spain on the UNCITRAL draft legislative guide on insolvency law**

##### **1. Introduction**

The Government of Spain welcomes the speedy conclusion of the Commission’s work on a legislative guide on insolvency law, which had been requested at the thirty-third session of the Commission (2000).

It also expresses its satisfaction at the extraordinary quality of the text. It therefore wishes, first, to congratulate the UNCITRAL secretariat for its intense and sustained efforts, and also all the States members and observers, international organizations and professional organizations which have made such an outstanding result possible.

The above remarks are justified because there is a need to update insolvency law in a wide range of geographical regions, which the guide aims to do with an extremely high level of expertise. Indeed, if the recommendations it contains are



followed, the level of legal certainty in international trade will grow, with the result that it is easy to foresee an enormous expansion in industrial, commercial and financial flows in that area, not to mention the beneficial effects for the internal elements of national economies.

The natural outcome of this process—an improved standard of living in all parts of the globe and, in particular, the most disadvantaged regions—is good reason to welcome the recent result of the Commission's work, since the guide is destined to become an important development tool because the legal reliability that sustains it and is advocated by it will increase business exchanges.

Spain recently adopted an Insolvency Law that brings to an end many decades of a disorganized legal regime governing insolvency. The Law, which, as indicated in its Statement of Purpose, is based on the UNCITRAL Model Law on Cross-Border Insolvency, contains the main features of the most innovative insolvency legislation from various European countries and, in some cases, other geographical regions, so it represents another milestone in the improvement and modernization of national legislation in this area.

It was thus inevitable that, in reading the guide, we would compare it with our new national Law. The result of this comparison is highly satisfactory, both because the set of basic issues relating to the insolvency regime is almost the same in both documents and because of the nature of the recommendations.

Our first comment might therefore be to recommend that the UNCITRAL secretariat suggest annexing to the guide some examples of the most recent legislation that develops and complements the legislative directions set out in the guide. Our new Insolvency Law should, of course, appear in such an annex.

It would also make sense for the work carried out in connection with our Insolvency Law, the preliminary discussions about the text among experts and the negotiations within Parliament itself should influence the direction of the only two fundamental comments that might be made about the guide: first, the question of the relations between the insolvency representative and the creditor committee and, second, the section dealing with voluntary restructuring negotiations.

Before broaching a few minor questions relating to these two topics and some other matters of form in the Spanish-language version, we should emphasize the overall relevance of the document both in the general and in the particular, from questions of detail to the broad sweep of the subject matter.

## **2. Voluntary restructuring negotiations and expedited reorganization proceedings**

The main difficulty is how to include such negotiations or proceedings in the legislative guide on insolvency law. The guide does not really deal with the contractual aspect, strictly speaking, but is rather a series of coordinates whereby the participants show their willingness to reduce their freedom of action for the common good of the proceedings.

On the other hand, so-called voluntary restructuring negotiations—and, where the two institutions have elements in common, expedited reorganization proceedings—have, as their name indicates, and as may be seen in the way their fundamental elements and the related recommendations are set forth, more of a

contractual or business nature, which, in a sense, does not form part of the traditional scope of insolvency law.

Since the system in question is innovative and useful, it would probably be preferable to detach the relevant section from the main body of the document and include it as an appendix, with a view to drawing legislators' attention to the fact that it would be useful and appropriate to give such a multilateral contractual procedure a more specific form in national regulations so that the harmful effects of a declared insolvency can be anticipated and avoided.

Reflecting on the above comment, on the basis of our new Insolvency Law, leads us to suggest an alternative way of incorporating out-of-court agreements between the debtor and a substantial proportion of its creditors into the legal system of insolvency. This is called "prior agreement proposal" in the Spanish Insolvency Law. Under this formula, the debtor can, at the start of insolvency proceedings, submit a payment plan and, where appropriate, a viability plan, with backing from creditors whose loans amount to more than one fifth of the total declared. Another point in favour of an approach that ensures the continuity of the debtor's business activities is the possibility of prompt agreement by the other creditors and a subsequent favourable court ruling, although the debtor will obviously need the support of its largest creditors.

This achieves all the positive effects of insolvency proceedings, especially that of holding the shares of individual creditors against the debtor's estate and any reorganization of the debtor's activities, with the agreement of the creditors (or at least a substantial proportion of them). It also ensures the transparency of the proceedings, which might otherwise be diminished, and a proper balance of the interests of all those involved. Obviously, however, if the "prior agreement proposal" does not meet with the approval of the majority of the creditors, the insolvency proceedings will have to take their ordinary course.

### **3. Relations between the insolvency representative and the creditor committee**

The guide treats the insolvency representative and the creditor committee as two separate entities. The logic behind such a separation may, however, break down in cases where the creditor committee exercises functions similar to those of the insolvency representative (see paragraphs 466 and 467, *in fine*).

It may therefore be preferable to broaden the concept of the insolvency representative so that, as a general rule, it would be a body made up of several people, whereas a one-person insolvency representative would be an exceptional arrangement for smaller-scale insolvencies.

We envisage that such a body, containing several members, would include a representative of the creditors (perhaps the unsecured creditors) and two other independent experts (in trade law and business studies). This may facilitate coordination between the creditors and the normal conduct of the tasks entrusted to the insolvency representative.

On the other hand, the form of the creditor committee might interfere with the functions of the insolvency representative and perhaps also with the participation of the creditors in the decision-making process. A further reading of these sections taken together (that relating to the meeting of creditors and that relating to the

committee) could result in a reduction in the number of functions entrusted to the committee if those functions were shared between an insolvency administration (the proposed court, particularly where it has creditor representation) and the meeting.

#### 4. Other comments

(a) It might be useful if the glossary contained in the document were set out in two columns, with one containing the Spanish word and the other the English. This would be a way to overcome the inevitable obstacles arising from language differences.

(b) In paragraphs 19 and 20, particularly the latter, it might be useful to indicate sectors that are particularly vulnerable in the context in question and which should be protected: banks, insurance and the securities market. These three sectors could also be mentioned in paragraphs 70 and 71 (as is already the case in paragraph 91).

(c) In the first paragraph of the section entitled “Purpose of legislative provisions”, under the recommendations in Part Two, chapter II, section A (Assets constituting the insolvency estate), there is no reference to the debtor’s insolvency estate, by contrast with references that may be found in parallel sections, where mention is made of the general framework of the objective or purpose that the legislative provisions should pursue.

(d) In the first line of paragraph 188, the phrase “de si” should read “si”.

(e) In the seventh line of paragraph 198, the word “billetes” is used, whereas the English word “assets” should—without checking the translation of the English in other places—be rendered as “activos” or “bienes”.

(f) The title of recommendation 44 is still to be translated and could read “venta al margen del curso ordinario de los negocios”.

(g) In the third sentence of paragraph 245, the phrase “una segunda clase de prestamistas será aquel” should perhaps be replaced by the phrase “una segunda clase de prestamistas será la de aquel” in order to retain the general meaning of the sentence, although this formulation is somewhat unfortunate.

(h) In paragraph 511, at the beginning of the second sentence, the affirmative “sí” should be replaced by the conditional “si”

(i) In line with the first substantive comment above, it would be useful to reconsider the terms used for expedited reorganization proceedings. More specifically, given the general tone of the document in Spanish, it is surprising that the present indicative (“constituyen”) rather than the conditional or future imperfect “pueden constituir”, “constituirían”, “constituirán”, etc. is used in paragraph (a) of the section “Purpose of legislative provisions” in the recommendations following paragraph 565.

(j) In the second line of the Spanish text of paragraph 614, “derechos jurídicos” should read “derechos legales”, (legal rights) by contrast with contractual rights.

(k) The first word of recommendation 173 should be “la” instead of “le”.

**K. Draft UNCITRAL Legislative Guide on Insolvency Law:  
revisions to A/CN.9/WG.V/WP.70**

**(A/CN.9/559 and Add.1-3) [Original: English]**

1. This note sets forth those terms of the glossary included in document A/CN.9/WG.V/WP.70 part I that were considered and finalized by Working Group V (Insolvency Law) at its thirtieth session (29 March-2 April 2004), together with some revisions to the “Notes on terminology”. Terms of the glossary that were not finalized by Working Group V (i.e. “claim”, “commencement of proceedings”, “netting”, “ordinary course of business”, “preference”, “priority”) and the terms set forth in A/CN.9/WG.V/WP.70 part I from “related person” to “voluntary restructuring negotiations”) will be set forth in a subsequent document for consideration by the Commission at its thirty-seventh session. The terms “application for commencement of insolvency proceedings”, “debtor”, “government authority”, and “priority rules” have been deleted.

**Introduction**

**2. Glossary**

**A. Notes on terminology**

2. The second sentence of paragraph 5 should be revised as follows:

“Although this reliance may be appropriate as a general principle, alternatives may be considered where, for example, the courts are unable to handle insolvency work (whether for reasons of lack of resources or lack of requisite experience) or supervision by ~~an administrative agency~~ some other authority is preferred (see part one, chapter III, Institutional framework).” *[delete second sentence]*

3. The following text has been suggested for addition to the end of paragraph 6.

“An authority which supports or has specified roles in insolvency proceedings, but which does not have adjudicative functions with respect to those proceedings, would not be regarded as within the meaning of the term “court” as that term is used in the *Guide*.”

4. Paragraph 7, “Reference to “the law”, should be deleted and the word “insolvency” should be re-inserted in the text of the *Guide*, as appropriate, to avoid confusion between references to the insolvency law and references to law other than the insolvency law.

**B. Terms and definitions**

5. The terms of the glossary should be revised as follows:

**(a) Administrative claim or expense**

Claims which include costs and expenses of the proceedings such as remuneration of the insolvency representative and any professionals employed by the insolvency representative, expenses for the continued operation of the debtor, debts arising from the exercise of the insolvency representative's functions and powers, costs arising from continuing contractual and legal obligations, and costs of proceedings.

**(b) Assets of the debtor**

Property, rights and interests of the debtor including rights and interests in property, whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor's interests in assets subject to a security interest or in third party-owned assets.

**(c) Avoidance provisions**

Provisions of the insolvency law 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 interests of creditors.

**(d) Burdensome assets**

Assets that may have no value or an insignificant value to the insolvency estate or that are burdened in such a way that retention would require expenditure that would exceed the proceeds of realization of the asset or give rise to an onerous obligation or a liability to pay money.

**(e) Cash proceeds**

Proceeds of the sale of encumbered assets, to the extent that the proceeds are subject to a security interest.

**(f) Centre of main interests**

The place where the debtor conducts the administration of its interests on a regular basis and that is therefore ascertainable by third parties.<sup>1</sup>

**(g) Creditor committee**

Representative body of creditors appointed in accordance with the insolvency law having consultative and other powers as specified in the insolvency law.

**(h) Discharge**

Release of a debtor from claims that were, or could have been, addressed in the insolvency proceedings.

**(i) Disposal**

Every means of transferring or parting with an asset or an interest in an asset, whether in whole or in part.

**(j) Encumbered asset**

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<sup>1</sup> EC Regulation No. 1346/2000 of 29 May 2000 on insolvency proceedings, recital (13).

**(j) Encumbered asset**

An asset in respect of which a creditor has obtained a security interest.

**(k) Equity holder**

The holder of issued stock or a similar interest that represents an ownership claim to a proportion of the capital of a corporation or other enterprise.

**(l) Establishment**

Any place of operations where the debtor carries out a non-transitory economic activity with human means and goods or services.<sup>2</sup>

**(m) Financial contract**

Any spot, forward, future, option or swap transaction involving interest rates, commodities, currencies, equities, bonds, indices or any other financial instrument, any repurchase or securities lending transaction, and any other transaction similar to any transaction referred to above entered into in financial markets and any combination of the transactions mentioned above.<sup>3</sup>

**(n) Insolvency**

When a debtor is generally unable to pay its debts as they mature or when its liabilities exceed the value of its assets.

**(o) Insolvency estate**

Assets of the debtor that are subject to the insolvency proceedings.

**(p) Insolvency proceedings**

Collective proceedings, subject to court supervision, either for reorganization or liquidation.

**(q) Insolvency representative**

Person or body, including one appointed on an interim basis, authorized in an insolvency proceeding to administer the reorganization or the liquidation of the insolvency estate.

**(r) Liquidation**

Proceedings to sell and dispose of assets for distribution to creditors in accordance with the insolvency law.

**(s) Lex fori concursus**

The law of the State in which the insolvency proceedings are commenced.

**(t) Lex rei situs**

The law of the State in which the asset is situated.

**(u) Netting agreement**

A form of financial contract between two or more parties that provides for one or more of the following:

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<sup>2</sup> UNCITRAL Model Law on Cross-Border Insolvency, art. 2 (f).

<sup>3</sup> UNCITRAL Convention on the Assignment of Receivables in International Trade (2002), art. 5 (k).

- (i) The net settlement of payments due in the same currency on the same date whether by novation or otherwise;
- (ii) Upon the insolvency or other default by a party, the termination of all outstanding transactions at their replacement or fair market values, conversion of such sums into a single currency and netting into a single payment by one party to the other; or
- (iii) The set-off of amounts calculated as set forth in subparagraph (ii) of this definition under two or more netting agreements.<sup>4</sup>

**(v) Pari passu**

The principle according to which similarly situated creditors are treated and satisfied proportionately to their claim out of the assets of the estate available for distribution to creditors of their rank.

**(w) Party in interest**

Any party whose rights, obligations or interests are affected by insolvency proceedings or particular matters in the insolvency proceedings, including the debtor, the insolvency representative, a creditor, an equity holder, a creditor committee, a government authority or any other person so affected. It is not intended that persons with remote or diffuse interests affected by the insolvency proceedings would be considered to be a party in interest.

**(x) Post-commencement claim**

A claim arising from an act or omission occurring after commencement of insolvency proceedings.

**(y) Priority claim**

A claim that will be paid before payment of general unsecured creditors.

**(z) Protection of value**

Measures directed at maintaining the economic value of a security interest during the insolvency proceedings (in some jurisdictions referred to as “adequate protection”). Protection may be provided by way of cash payments, provision of security interests over alternative or additional assets or by other means as determined by a court to provide the necessary protection.

## **A/CN.9/559/Add.1**

### **Draft Legislative Guide on Insolvency Law:revisions to A/CN.9/WG.V/WP.70**

#### **ADDENDUM**

1. This note sets forth revisions and additions to the recommendations in documents A/CN.9/WG.V/WP.70 parts I and II and A/CN.9/WG.V/WP.72 based upon the deliberations of Working Group V at its thirtieth session (March/April

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<sup>4</sup> UNCITRAL Convention on the Assignment of Receivables in International Trade (2002), art. 5 (1).

2004) (see A/CN.9/551 for the report of that meeting). The numbering of those recommendations remains unchanged; where the order of recommendations has been changed, the numbering is not in sequence. Numbers such as “(40A)” indicate recommendations that were added during the thirtieth session of Working Group V. The use of square brackets indicates text added or revised subsequent to the thirtieth session of Working Group V.

2. For reasons of economy, recommendations that have not been revised are not reproduced in this document and remain as contained in A/CN.9/WG.V/WP.70 (recommendations 1-187) and A/CN.9/WG.V/WP.72 (recommendations 179-184 on applicable law). Those parts of the recommendations set forth in this document that have not been amended are shown as “(No change)”. Recommendations on reorganization (A/CN.9/WG.V/WP.70, part II chapter IV) are set forth in A/CN.9/559/Add.3. Footnotes to recommendations have not been reproduced in this document, unless they have been amended or deleted.

## **Part one. Designing the key objectives and structure of an effective and efficient insolvency law**

(1) The text of recommendations (1) is set forth in paragraph 551 of document A/CN.9/551.

(2) The text of recommendation (2) is set forth as recommendation 7 of document A/CN.9/WG.V/WP.70, part I.

(3) The text of recommendation (3) is set forth as recommendation 179 of document A/CN.9/WG.V/WP.72

(4) The text of recommendation (4) is set forth as recommendation 74(a) in document A/CN.9/WG.V/WP.70, part II and should be amended as follows:

The insolvency law should specify that where a security interest is effective and enforceable under other law, it would be recognized in insolvency proceedings as effective enforceable.

(5) The insolvency law should include a modern, harmonized and fair framework to address effectively instances of cross-border insolvency. Enactment of the UNCITRAL Model Law on Cross-Border Insolvency is recommended.

(6) The text of recommendation (6) is set forth as recommendation 2 in paragraph 112 of document A/CN.9/551.

(7) The text of recommendation (7) is set forth as recommendation 3 in paragraph 113 of document A/CN.9/551. The following 5 subparagraphs should be added:

- (..) Identification of the assets of the debtor that will be subject to the insolvency proceedings and constitute the insolvency estate;
- (..) Rights and obligations of the debtor;
- (..) Duties and functions of the insolvency representative;
- (..) Functions of the creditors and creditor committee;



(..) Costs and expenses relating to the insolvency proceedings;

and the following subparagraphs amended as follows:

(d) Protection of the insolvency estate against the actions of creditors, the debtor itself and the insolvency representative, and where the protective measures apply to secured creditors, the manner in which the economic value of the security interest will be protected during the insolvency proceedings;

(j) The treatment of claims and their ranking for the purposes of distributing the proceeds of liquidation;

(k) Delete;

(m) Discharge or dissolution of the debtor.

## **Part Two: Core provisions for an effective and efficient insolvency law**

### **I. Application and commencement**

#### **A. Eligibility and jurisdiction**

##### *Eligibility*

(1) The insolvency law should govern insolvency proceedings against all debtors that engage in economic activities, whether natural or legal persons, including State-owned enterprises, and whether or not those economic activities are conducted for profit.

#### **B. Commencement of proceedings**

##### *Commencement on creditor application*

(13) The insolvency law generally should specify that, where a creditor makes the application for commencement:

(a) *(No change)*

(b) The debtor be given the opportunity to respond to the application, by contesting the application, consenting to the application or, where the application seeks liquidation, requesting the commencement of reorganization proceedings; and

(c) *(No change)*

#### **C. Applicable law governing in insolvency proceedings**

##### *Recognition of rights and claims arising before commencement*

(179) The insolvency law should recognize rights and claims arising under general law, whether domestic or foreign, except to the extent of any express limitation in the insolvency law.

## II. Treatment of assets on commencement of insolvency proceedings

### A. Assets constituting the insolvency estate

#### Purpose of legislative provisions

The purpose of provisions relating to the insolvency estate is to:

(a) Identify those assets that will be included in the estate, including the debtor's interests in assets subject to a security interest and in third party-owned assets; and

(b) *(No change)*.

#### Contents of legislative provisions

##### *Assets constituting the estate*

(24) The insolvency law should specify that the estate should include:

(a) Assets of the debtor<sup>28</sup> including the debtor's interest in assets subject to a security interest and in third party-owned assets;

(b)-(c) *(No change)*.

(24A) The insolvency law should specify the date from which the estate is to be constituted, being either the date of application for commencement or the effective date of commencement of insolvency proceedings.

### B. Protection and preservation of the insolvency estate

#### *Provisional measures*

(27) The insolvency law should specify that the court may grant relief of a provisional nature, at the request of the debtor, creditors or third parties, where relief is needed to protect and preserve the value of the assets of the debtor or the interests of creditors, between the making of an application to commence insolvency proceedings and commencement of the proceedings,<sup>40</sup> including:

(a) Staying execution against the assets of the debtor, including actions to make security interests effective against third parties and enforcement of security interests;

(b)-(c) *(No change)*; and

<sup>28</sup> Ownership of assets would be determined by reference to the relevant applicable law, where the term "assets" is defined broadly to include property, rights and interests of the debtor, including the debtor's rights and interests in third-party owned assets.

<sup>40</sup> The insolvency law should indicate the time of effect of an order for provisional measures e.g. at the time of the making of the order, retrospectively from the commencement of the day on which the order is made or some other specified time. (See para. 192.)

(d) Any other relief of the type applicable [or available] on commencement of proceedings [under recommendations 34 and 36].

*Notice*

(31) The insolvency law should specify that where the debtor or other party in interest affected by a provisional measure is not given notice of the application for that provisional measure, the debtor or other party in interest affected by the provisional measures has the right, upon urgent application, to be heard promptly<sup>42</sup> on whether the relief should be continued.

*Termination of provisional measures on commencement*

(33) The insolvency law should specify that provisional measures terminate when an application for commencement is dismissed or the measures applicable on commencement take effect, unless the court continues the effect of the provisional measures.

*Measures applicable on commencement*

(34) The insolvency law should specify that, on commencement of insolvency proceedings:

- (a) *(No change)*;
- (b) Actions to make security interests effective against third parties and to enforce security interests are stayed;<sup>45</sup>
- (c)-(e) *(No change)*.

*Relief from measures applicable on commencement*

(38) The insolvency law should specify that a secured creditor may request the court to grant relief from the type of measures applicable on commencement on grounds that may include that:

- (a) *(No change)*;
- (b) The value of the encumbered asset is diminishing [as a result of the commencement of insolvency proceedings] and the secured creditor is not protected against that diminution of value; and
- (c) *(No change)*.

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<sup>42</sup> Any time limit included in the insolvency law should be short in order to prevent the loss of value of the debtor's business.

<sup>45</sup> If law other than the insolvency law permits those security interests to be made effective within certain time limits or grace periods, it is desirable that the insolvency law recognize those periods and permit the interest to be made effective where the commencement of insolvency proceedings occurs before expiry of the grace period. Where law other than the insolvency law does not include such grace periods, the stay applicable on commencement would operate to prevent the security interest being made effective (for further discussion see paras. ... above and the UNCITRAL Legislative Guide to Secured Transactions).

*Protection of the value of the encumbered asset*

(39) The insolvency law should specify that upon application to the court, a secured creditor should be entitled to protection of the value of the assets in which it has a security interest. The court may grant appropriate measures of protection that may include:

- (a)-(c) (No change).

**C. Use and disposal of assets****Purpose of legislative provisions**

The purpose of provisions on use and disposal of assets is to:

- (a) Permit the use and disposal of assets, including encumbered assets and assets owned by a third party in the insolvency proceedings and specify the conditions for their use and disposal;
- (b) Establish the limits to powers of use and disposal;
- (c) Notify creditors of proposed use and disposal, where appropriate;
- (d) Provide for the treatment of burdensome assets.

**Contents of legislative provisions***Power to use and dispose of assets of the estate*

(40) The insolvency law should permit:

- (a) The use and disposal of assets of the estate (including assets subject to security interests) in the ordinary course of business, except cash proceeds; and
- (b) The use and disposal of assets of the estate (including assets subject to security interests) outside the ordinary course of business, subject to the requirements of recommendations (41) and (43).

*Further encumbrance of encumbered assets*

(40A) The insolvency law should specify that assets subject to security interests may be further encumbered, subject to the requirements of recommendations 50, 51 and 52.

*Use of third party owned assets*

(40B) The insolvency law should specify that the insolvency representative may use assets owned by third parties and in the possession of the debtor provided specified conditions are satisfied, including:

- (a) The interests of the third party will be protected against diminution in the value of the assets; and
- (b) The costs under the contract of [continued performance of the contract][use of the assets] will be paid as an administrative expense.

*Procedure for notification of disposal*

(41) The insolvency law should specify that adequate notice of any disposal conducted outside the ordinary course of business is given to creditors<sup>55</sup> and that they have the opportunity to be heard by the court.

(42) The insolvency law should specify that notification of public auctions be provided in a manner that will ensure the information is likely to come to the attention of interested parties.

*Ability to sell assets of the estate free and clear of encumbrances and other interests*

(43) The insolvency law should permit the insolvency representative to sell assets that are encumbered or subject to other interests free and clear of those encumbrances and other interests, outside the ordinary course of business, provided that:

- (a)-(d) (No change).

*Use of cash proceeds*

(43A) The insolvency law should permit the insolvency representative to use [and dispose of] cash proceeds if:

- (a) The secured creditor consents to such use [or disposal]; or
- (b) The secured creditor was given [notice of the proposed use [or disposal] and] an opportunity to be heard by the court; and
- (c) The interests of the secured creditor will be protected against diminution in the value of the cash proceeds.

**D. Post-commencement finance***Obtaining post-commencement finance*

(49) The insolvency law should facilitate and provide incentives for post-commencement finance to be obtained by the insolvency representative where the insolvency representative determines it to be necessary for the continued operation or survival of the business of the debtor or the preservation or enhancement of the value of the assets of the estate. The insolvency law may require authorization by the court or creditors (or the creditor committee).

*Recommendation 53 “Priority for post-commencement finance” should be relocated before Recommendation 50 which addresses security for post-commencement finance.*

*Security for post-commencement finance*

(52) The insolvency law should specify that, where the existing secured creditor does not agree, the court may authorize the creation of a security interest having priority over pre-existing security interests provided specified conditions are satisfied, including:

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<sup>55</sup> When the assets are encumbered assets or subject to other interests, recommendation (43) applies.

- (a)-(b) *(No change)*;
- (c) The interests of the existing secured creditor will be protected.

*Effect of conversion on post-commencement finance*

(54) The insolvency law should specify that where reorganization proceedings are converted to liquidation, any priority provided to post-commencement finance in the reorganization should continue to be recognized in the liquidation.

## **E. Treatment of contracts**

*Automatic termination [and acceleration] clauses*

(56) The insolvency law should specify that any contract clause that automatically terminates [or accelerates] a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor:

- (a)-(b) *(No change)*.

(62) The insolvency law should specify that where a contract is continued or rejected, the counterparty be given notice of the continuation or rejection, including its rights in respect to submitting a claim and the time in which the claim should be submitted, and permit the counterparty to [object to that decision] [be heard by the court].

*Continuation of contracts where the debtor is in breach*

(65) The insolvency law should specify that where the debtor is in breach under a contract the insolvency representative can continue the performance of that contract, provided the breach is cured, the non-breaching counterparty is substantially returned to the economic position it was in before the breach, and the estate is able to perform under the continued contract.

*Performance prior to continuation or rejection*

(66) The insolvency law should specify that the insolvency representative may accept [or require] performance from the counterparty to a contract prior to continuation or rejection of the contract. Claims of the counterparty arising from performance accepted [or required] by the insolvency representative prior to continuation or rejection of the contract should be payable as an administrative expense:

- (a) If the counterparty has performed the contract the amount of the administrative expense should be the [costs under the contract of the benefits conferred on the estate] [contractual price of the performance].

- (b) If the insolvency representative uses assets owned by a third party that are in the possession of the debtor subject to contract, that party should be protected against diminution of the value of those assets and have an administrative claim in accordance with paragraph (a).

*Damages for subsequent breach of a continued contract*

(67) The insolvency law should specify that where a decision is made to continue performance of a contract, damages for the subsequent breach of that contract should be payable as an administrative expense.

*Assignment of contracts*

(70) Where the counterparty objects to assignment of a contract, the law may permit the court to nonetheless approve the assignment provided:

(a)-(c) (No change);

(d) The debtor's default [whether pre- or post-commencement] under the contract is cured before assignment.

(71) The insolvency law may specify that where the contract is assigned, the assignee will be substituted for the debtor as the contracting party with effect from the date of the assignment and the estate will have no further liability under the contract.

**F. Avoidance proceedings***Avoidable transactions*

(73) The insolvency law should include provisions which apply retroactively and are designed to overturn transactions, involving the debtor or assets of the estate and which have the effect of either reducing the value of the estate or upsetting the principle of equitable treatment of creditors. The insolvency law should specify the following types of transactions as avoidable:

(a) Transactions intended to defeat, delay or hinder the ability of creditors to collect claims where the effect of the transaction was to put assets beyond the reach of creditors [or potential creditors] or to otherwise prejudice the interests of creditors;

(b) Transactions where a transfer of an interest in property or the undertaking of an obligation by the debtor was a gift or was made in exchange for a nominal or less than equivalent value or for inadequate value which occurred at a time when the debtor was insolvent or as a result of which the debtor became insolvent (undervalued transactions); and

(c) (No change).

*Security interests*

(74) The insolvency law should specify that notwithstanding that a security interest is effective and enforceable under other law, it may be subject to the avoidance provisions of the insolvency law on the same grounds as other transactions.

*Related person transactions*

(76) The insolvency law may specify that the suspect period for avoidable transactions involving related persons is longer than for transactions with unrelated persons.

*Conduct of avoidance proceedings*

(79) The insolvency law should specify that the insolvency representative have the principal responsibility to commence avoidance proceedings. The insolvency law may also permit any creditor to commence avoidance proceedings with the agreement of the insolvency representative and where the insolvency representative does not agree, the creditor may seek leave of the court to commence such proceedings.

*Funding of avoidance proceedings*

(79A) The insolvency law should specify that the costs of avoidance proceedings be paid as administrative expenses.

(80) Where the insolvency representative elects not to pursue the avoidance of particular transactions on the basis, for example, of an assessment that the transactions are not likely to be avoided or that pursuing those transactions will impose excessive costs<sup>71</sup> upon the insolvency estate, the insolvency law may provide alternative approaches to address the pursuit and funding of avoidance proceedings.

*Time limits for commencement of avoidance proceedings*

(81) The insolvency law or applicable procedural law should specify the time period within which an avoidance proceeding may be commenced. That time period should begin to run on the commencement of insolvency proceedings. In respect of transactions referred to in recommendation (73) which have been concealed and which the insolvency representative could not be expected to discover, the insolvency law may provide that the time period commences at the time of discovery.

*Elements of avoidance and defences*

(82) The insolvency law should specify the elements to be proved in order to avoid a particular transaction, the party responsible for proving those elements and specific defences to avoidance. Those defences may include that the transaction was entered into in the ordinary course of business prior to commencement of insolvency proceedings, [that the transaction was entered into pursuant to voluntary restructuring negotiations before the commencement of insolvency proceedings] or, [in liquidation proceedings,] or that the transaction was entered into in the course of reorganization proceedings that preceded the liquidation proceedings. The law may also establish presumptions and permit shifts in the burden of proof to facilitate avoidance proceedings.

*Liability of counterparties to avoided transactions*

(83) The insolvency law should specify that a counterparty to a transaction that has been avoided must return to the estate the assets obtained or, if the court so orders, make a cash payment to the estate for the value of the transaction. The court should

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<sup>71</sup> This refers to an appraisal of the costs and benefits of an avoidance action and an implicit rule that if the costs of proceedings would exceed the benefits to be recovered for the estate, those proceedings should not go ahead.



determine whether the counterparty to an avoided transaction would have an ordinary unsecured claim.

## H. Financial contracts and netting

### Purpose of legislative provisions

The purpose of provision on netting and set-off in the context of financial transactions is to reduce the potential for systemic risk that could threaten the stability of financial markets by providing certainty with respect to the rights of parties to a financial contract when one of those parties fails to perform for reasons of insolvency. These recommendations are not intended to apply to transactions that are not financial contracts, which would remain subject to the general law applying to set-off and netting.

### Contents of legislative provisions

(92) Financial contracts should be defined broadly enough to encompass existing varieties of financial contracts and to accommodate new types of financial contracts as they appear.

## III. Participants

### A. The debtor

#### *Obligations*

(95) The insolvency law should clearly specify the debtor's obligations in respect of insolvency proceedings. Those obligations should arise on the commencement of, and continue throughout, those proceedings. The obligations should include the obligation:

(a)-(b) *(No change)*;

(i)-(iv) *(No change)*;

(v) Creditors and their claims, prepared in cooperation with the insolvency representative and revised and amended by the debtor as claims are verified and admitted or denied;

(c) To cooperate with the insolvency representative to enable the insolvency representative to take effective control of the estate and to facilitate or cooperate in the recovery by the insolvency representative of the assets, or control of the assets of the estate, wherever located and business records;

(d) *(No change)*.

#### *Confidentiality*

(96) The insolvency law should specify protections for information provided by the debtor [or concerning the debtor] that is commercially sensitive or confidential.

*The debtor's role in continuation of the business*

(97A) The insolvency law should specify that a debtor in possession would have the powers and functions of an insolvency representative, except for the right to remuneration.

**B. The insolvency representative***Conflict of interest*

(100) The insolvency law should require the disclosure of a conflict of interest, a lack of independence or circumstances that may lead to a conflict of interest or lack of independence by:

(a) A person proposed for appointment as an insolvency representative or a person appointed as an insolvency representative, where the conflict of interest or the circumstances that may lead to a conflict of interest or lack of independence arises in the course of insolvency proceedings; and

(b) *(No change)*.

*Duties and functions of the insolvency representative*

(104) The insolvency law should specify that the insolvency representative have an obligation to protect and preserve the assets of the estate. The insolvency law should specify the insolvency representative's duties and functions with respect to the administration of the proceedings and preservation and protection of the estate, [including continued operation of the debtor's business].

*Liability*

(105) The insolvency law should specify the consequences of the insolvency representative's failure to perform, or to properly perform, its duties and functions under the law and any related standard of liability imposed.

**C. Creditors—participation in insolvency proceedings***Convening meetings of creditors*

(112) The insolvency law may require a first meeting of creditors to be convened within a specified time period after commencement to discuss certain matters [specified in the law]. The insolvency law may also permit the court, the insolvency representative or creditors holding a specific percentage of the total value of unsecured claims to request the convening of a meeting of creditors generally and specify the circumstances in which such a meeting of creditors may be convened. The insolvency law should specify the party responsible for giving notice to creditors of such a meeting.

*Creditor representation*

(113) The insolvency law should facilitate the active participation of creditors in insolvency proceedings such as through a creditor committee, special representative or

other mechanism for representation.<sup>86</sup> The insolvency law should specify whether a committee or other representation is required in all insolvency proceedings. Where the interests and categories of creditors involved in insolvency proceedings are diverse and participation will not be facilitated by the appointment of a single committee or representative, the insolvency law may provide for the appointment of different creditor committees or representatives.

*- Creditors that may be appointed to a creditor committee*

(115) The insolvency law should specify the creditors that are eligible to be appointed to a committee. The creditors who may not be appointed to the creditor committee would include related persons and others who for any reason might not be impartial. The insolvency law should specify whether or not a creditor's claim must be admitted before the creditor is entitled to be appointed to a committee.

*- Rights and functions of a creditor committee*

(117) The insolvency law should specify the rights and functions of the creditor committee in insolvency proceedings, which may include:

- (a)-(c) *(No change)*; and
- (d) The right to be heard in the proceedings.

*Recommendations on Chapter IV. Reorganization are contained in document A/CN.9/559/Add.3*

## **V. Management of proceedings**

### **A. Treatment of creditor claims**

*Requirement to submit*

(154)(a) The insolvency law should require creditors who wish to participate in the proceedings to submit their claims,<sup>100</sup> and that the basis and amount of the claim be specified. The insolvency law should minimize the formalities associated with submission of claims. The insolvency law should permit claims to be submitted using different means, including mail and electronic means.

(154)(b) The insolvency law may permit claims that are undisputed to be admitted by reference to the list of creditors and claims prepared by the debtor in cooperation with the insolvency representative or the court or the insolvency representative may require a creditor to provide evidence of its claim. The insolvency law should not require that in all cases a creditor must appear in person to prove its claim.

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<sup>86</sup> See recommendation (97) and the continuing role of the debtor in reorganization. Where the debtor remains in possession of the business, a creditor committee or other creditor representative will have an important role to play in overseeing and, where necessary, reporting on the activities of the debtor.

<sup>100</sup> Footnote deleted.

*Timing of submission of claims*

(158) The insolvency law should specify the time period after commencement in which claims may be submitted, which time period should be adequate to allow creditors to submit their claims.<sup>105a</sup>

*Foreign currency claims*

(160) Where claims are denoted in foreign currency, the insolvency law should specify the circumstances in which those claims must be converted and the reasons for conversion. Where conversion is required, the insolvency law should specify that the claim will be converted into local currency by reference to a specified date, such as the effective date of commencement of insolvency proceedings.

*Admission or denial of claims*

(162) The insolvency law should permit the insolvency representative to admit or deny any claim, in full or in part. Where the claim is to be denied [or subjected to treatment under recommendation 169 as a claim by a related person], whether in full or in part, notice of the reasons for the decision to deny should be given to the creditor.

(166) The insolvency law should permit unliquidated claims to be admitted provisionally, pending determination of the amount of the claim by the insolvency representative.

(167) The insolvency law should provide that the insolvency representative may determine the portion of a secured creditor's claim that is secured and the portion that is unsecured by valuing the encumbered asset.

(164) The insolvency law should permit an interested party to dispute any submitted claim, either before or after admission, and request review of that claim by the court.

(163) The insolvency law should permit creditors whose claims have been denied [or subjected to treatment under recommendation 169 as a claim by a related person], whether in full or in part, to request, within a specified period of time after notification of the decision to deny the claim, the court to review their claim.

(165) The insolvency law should specify that, claims disputed in the insolvency proceedings can be admitted provisionally by the insolvency representative pending resolution of the dispute by the court.

**B. Priorities and distribution of proceeds***Priority claims*

(172) The insolvency law should minimize the priorities accorded to unsecured claims. The insolvency law should set out clearly the classes of claims, if any, that will be entitled to be satisfied in priority in insolvency proceedings.

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<sup>105a</sup> Where proceedings involve foreign creditors, longer time periods may be required to facilitate submission of claims. Also, it is desirable that claims be made at an early stage of the proceedings so that the insolvency representative will be aware of the claims involved, of the assets subject to security interest and of the value of those assets and claims.

*Ranking of claims*

(174) The insolvency law should specify that claims other than secured claims, are ranked in the following order:<sup>112</sup>

- (a)-(c) *(No change)*;
- (d) Deferred claims or claims subordinated under the law.

## VI. Conclusion of proceedings

### A. Discharge

(185) Where the insolvency law provides that certain debts are excluded from the discharge, those debts should be kept to a minimum to facilitate the debtor's fresh start and should be set forth in the insolvency law. Where the insolvency law provides that the discharge may be subject to conditions, those conditions should be kept to a minimum to facilitate the debtor's fresh start and should also be set forth in the insolvency law.

### B. Conclusion of proceedings

*Liquidation*

(186) The insolvency law should specify the procedures by which liquidation proceedings should be closed following final distribution or a determination that no distribution can be made.

*Reorganization*

(187) The insolvency law should specify the procedures by which reorganization proceedings should be closed when the reorganization plan is fully implemented or at an earlier date determined by the court.

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<sup>112</sup> The insolvency law may provide for further ranking of claims within each of the ranks set forth in paras. (a), (b) and (d). So, for example, workers' claims may be ranked as a class of their own and granted a rank higher than that accorded to claims of the State and the social security system, in accordance with Article 8(1) of the ILO Protection of Workers' Claims (Employer's Insolvency) Convention, 1992 (No. 173). Where all creditors within a rank cannot be paid in full, the order of payment should reflect any further ranking specified in the insolvency law for claims of the same rank.

**Draft Legislative Guide on Insolvency Law:revisions to A/CN.9/WG.V/WP.70**

## ADDENDUM

1. This note sets forth revisions and additions to the commentary in documents A/CN.9/WG.V/WP.70 parts I and II based upon the deliberations of Working Group V at its thirtieth session (see A/CN.9/551 for the report of that meeting).

**Introduction****1. Organization and scope of the Guide**

1. Add the following to the fifth sentence of paragraph 1 after the words, “emphasis on reorganization”:

“... against a debtor, whether a legal or natural person, that is engaged in economic activity. Issues specific to the insolvency of individuals not so engaged, such as consumers, are not addressed.”

2. Add the following to the end of paragraph 1:

“... to facilitate consideration of cross-border insolvency issues. It should be noted, however, that a model law generally would be used differently to a legislative guide. Specifically, a model law is a legislative text recommended to States for enactment as part of national law, with or without modification. As such, model laws generally propose a comprehensive set of legislative solutions to address a particular topic, and the language employed supports direct incorporation of the provisions of the model law into national law. The focus of a legislative guide, on the other hand, is upon providing guidance to legislators and other users, and for that reason they generally include a substantial commentary discussing and analysing relevant issues. It is not intended that the recommendations of a legislative guide be enacted as part of national law as such. Rather, they outline the core issues that it would be desirable to address in that law, with some recommendations providing specific guidance on how certain legislative provisions might be drafted.”

3. Add the following to paragraph 2, after the fourth sentence:

“The recommendations adopt different levels of specificity, depending upon the issue in question. A number employ legislative language to detail the manner in which a particular issue should be addressed in an insolvency law, reflecting a high degree of consensus on the particular approach to be adopted. Other recommendations identify key points to be addressed by an insolvency law with respect to a particular topic and offer possible alternative approaches, indicating the existence of different policy and procedural concerns that might need to be considered.”

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## **Part One: Designing the key objectives and structure of an effective and efficient insolvency law**

### **II. Mechanisms for resolving a debtor's financial difficulties**

4. Add the following introduction before paragraph 31:

“The following discussion focuses upon different mechanisms that have been developed for resolving a debtor's financial difficulties, and have proven to be useful tools for addressing those difficulties. These include proceedings conducted under the insolvency law, whether reorganization or liquidation; negotiations with creditors entered into by the debtor on a voluntary basis and conducted essentially outside of the formal insolvency law; and administrative processes that have been developed in a number of countries to address, specifically, systemic financial problems in the banking sector. The latter have been included simply for information and it is not suggested that they should be developed to address the insolvency of debtors engaged in economic activity. Similarly, the facilitating agency used to supervise these particular administrative processes should not be confused with the authorities, other than judicial authorities, that might be developed to supervise insolvency proceedings concerning economic debtors that are contemplated by the use of the term ‘court’ in this Guide.”

## **Part Two: Core provisions for an effective and efficient insolvency law**

### **II. Treatment of assets on commencement of insolvency proceedings**

#### **D. Post-commencement finance**

5. Paragraphs 246-250 should be revised as follows:

3. **Attracting post-commencement finance—providing priority or security**

246. A number of different approaches can be taken to attracting post-commencement finance and providing for repayment. Trade credit or indebtedness incurred in the ordinary course of business by an insolvency representative (or a debtor in possession) may be treated automatically as an administrative expense. When obtaining credit or incurring indebtedness is essential to maximizing the value of assets and the credit or finance is not otherwise available as an administrative expense or is to be incurred outside the ordinary course of business, the court may authorize that credit or debt to be incurred as an administrative expense, to be afforded super-priority ahead of other administrative expenses or to be supported by the provision of security on unencumbered or partially encumbered assets.

**(a) Establishing priority**

248. Where the business of the debtor continues to operate after commencement of insolvency proceedings, either incident to an attempted reorganization or to preserve value by sale as a going concern, the expenses incurred in the operation of the business typically are entitled under a number of insolvency laws to be paid as administrative expenses. Administrative priority creditors generally do not rank ahead of a secured creditor with respect to its security interest, but are generally afforded a first priority (see chapter V.B) that will rank ahead of ordinary unsecured creditors and would be paid before any other statutory priorities, for example, taxes or social security claims. Suppliers of goods and services would only continue to supply goods and services to the insolvency representative on credit if they had a reasonable expectation of payment ahead of pre-commencement unsecured creditors. In some cases, this priority is afforded on the basis that the new credit or lending is extended to the insolvency representative, rather than to the debtor, and becomes an expense of the insolvency estate. Some insolvency laws require such borrowing or the incurring of such credit to be approved by the court or by creditors, while other laws provide that the insolvency representative may obtain the necessary credit or finance without approval, although this may involve an element of personal liability and, where it does, is likely to result in reluctance to seek new finance.

250. Other insolvency laws provide for a “super” administrative priority if credit or finance is not available where ranked as an administrative claim which is *pari passu* with other administrative claims such as fees of the insolvency representative or professional employed in the case. The “super” priority ranks ahead of administrative creditors.

**(b) Granting security**

247. Where the lender requires security, it can be provided on unencumbered property or as a junior or lower security interest on already encumbered property where the value of the encumbered asset is sufficiently in excess of the amount of the pre-existing secured obligation. In that case, no special protections will generally be required for the pre-existing secured creditors, as their rights will not be adversely affected unless circumstances change at a later time (such as that the value of the encumbered assets begins to diminish) and they will retain their pre-commencement priority in the encumbered asset, unless they agree otherwise. Frequently, the only unencumbered assets that may be available for securing post-commencement finance will be assets recovered through avoidance proceedings; however providing security on such assets is controversial under some insolvency laws and is not permitted.

249. Some insolvency laws provide that new lending may be afforded some level of priority over existing secured creditors, sometimes referred to as a “priming lien”. In countries where this latter type of priority is permitted, insolvency courts recognize the risk to the existing secured creditors and authorize these types of priority reluctantly and as a last resort. The granting of such a priority may be subject to certain conditions such as the provision of notice to affected secured creditors and the opportunity for them to be heard by the court; proof by the debtor that it is unable to obtain the necessary finance without the priority; and the provision of protection for any diminution of the economic value of encumbered assets, including by a sufficient excess in the value of the encumbered asset. In some legal systems, all of the priority, super-priority, security and priming lien options for attracting post-commencement



finance are available. As a general rule, the economic value of the rights of pre-existing secured creditors should be protected so that they will not be harmed. If necessary (and as already discussed in relation to protection of the insolvency estate: see chapter II.B.8) this can be achieved by making periodic payments or providing security rights in additional assets in substitution for any assets that may be used by the debtor or encumbered in favour of new lending.

### **A/CN.9/559/Add.3**

#### **Revisions to A/CN.9/WG.V/WP.70: Reorganization**

##### ADDENDUM

1. This note sets forth revisions and additions to the commentary and recommendations of chapter IV on reorganization in document A/CN.9/WG.V/WP.70 part II based upon the deliberations of Working Group V at its thirtieth session (March/April 2004) (see document A/CN.9/551 for the report of that meeting). The numbering of the commentary and recommendations remains unchanged; where the order of the paragraphs or recommendations has been changed, the numbering is not in sequence. With respect to recommendations, the use of square brackets indicates text added or revised subsequent to the thirtieth session of Working Group V.

2. For reasons of economy, commentary and recommendations that have not been revised are not reproduced in this document and remain as contained in A/CN.9/WG.V/WP.70 part II; those paragraphs and parts of the recommendations set forth in this document that have not been amended are shown as “*No change*”. Footnotes to recommendations have not been reproduced in this document, unless they have been amended or deleted.

## **IV. Reorganization**

### **5. Approval of a plan**

506. Designing the provisions of an insolvency law on approval of the plan requires a balance to be achieved between a number of competing considerations, such as whether or not creditors should vote on approval of the plan in classes, whether all creditors are entitled to vote on the plan and the manner in which dissenting creditors will be treated. Some underlying principles are that creditors whose rights are impaired by the plan, including secured creditors, can only be bound by a plan if they have been given the opportunity to vote on that plan; that secured creditors should vote separately from unsecured creditors; that creditors of a class should each receive the same treatment under the plan; and that a dissenting class of creditors that is to be bound to the plan should receive as least as much as they would have received in liquidation proceedings.

#### *(i) Classification of claims*

506A. Insert paragraph 506, beginning with the third sentence.

(ii) *Treatment of dissenting creditors*

507. No change.

508. Revise the second and third sentences as follows:

So, for example, the law might provide that dissenting creditors could not be bound unless assured of certain treatment. As a general principle, that treatment might be that the creditors will receive at least as much under the plan as they would have received in liquidation proceedings.

(a) **Procedures for approval**

509. In the first sentence, add the words “including equity holders” after “other interested parties”.

510. In the first sentence, change the reference to “required to vote” to “entitled to vote”.

(i) *Treatment of abstaining or non-participating creditors*

510A. Insert paragraph 510, commencing with the third sentence.

(ii) *Use of presumptions*

511. No change.

(b) **Approval by secured and priority creditors**

512. In the second sentence, change the reference to “required to vote” to “entitled to vote”, otherwise no change.

513. At the end of the second sentence, add the words “before creditors without priority are paid”. In the last sentence, change the reference “required to vote” to “entitled to vote”.

515. Recognizing the need for secured creditors to participate, a second approach provides for secured and priority creditors to vote as classes separate from unsecured creditors on a plan that would impair the terms of their claims, or to otherwise consent to be bound by the plan. Adopting an approach that allows for secured and priority creditors to vote as a separate class provides a minimum safeguard for the adequate protection of such creditors and recognises that the respective rights and interests of secured and priority creditors differ from those of unsecured creditors. In many cases, however, the rights of secured and priority creditors will differ from each other and it may not be feasible to require all secured creditors to vote in a single class or priority creditors to vote in a single class. In such cases, some laws provide that each secured creditor forms a class of its own. Where secured creditors do vote, the requisite majority of a class of secured creditors would generally be the same as that required for approval by unsecured creditors, although there are examples of laws that require different majorities depending upon the manner in which secured creditors rights are to be affected by the plan (e.g. one law provides that a three-quarter majority is required where the maturity date is to be extended and a four-fifths majority where the rights are otherwise to be impaired).

516. Third and fourth sentences moved to 532A.

514. In the last sentence, change the reference “required to vote” to “entitled to vote”.

517. No change.

**(c) Approval by ordinary unsecured creditors**

518. No change.

*(i) Classes of unsecured creditors*

519. No change.

520. Revise the second and third sentences as follows:

The creation of these classes is designed to enhance the prospects of reorganization in at least three respects by providing: a useful means of identifying the varying economic interests of unsecured creditors; a framework for structuring the terms of the plan and ensuring that all creditors in a class receive the same treatment; and a means for the court to utilize the requisite majority support of one class to make the plan binding on other classes which do not support the plan. Since the creation of different classes has the potential to complicate the voting procedure, it may be desirable only where there are compelling reasons for special treatment of some ordinary unsecured creditors, such as where there is a large number of creditors that lack a common economic interest and the treatment to be offered to them under the plan differs.

*(ii) Determination of classes*

521. No change.

**(d) Approval by equity holders**

522. Add the following after the second sentence:

Where equity holders are entitled to vote, they should be provided with the same notice and information as other creditors entitled to vote.

523. No change.

**(e) Related persons**

524. No change.

**(f) Requirements for approval of the plan**

525. No change.

*(i) Where voting is not conducted in classes*

526. No change.

*(ii) Where voting is conducted by class*

527. Add the following sentence at the end of the paragraph:

Whichever approach is adopted, it is important that it be set forth clearly in the law to provide certainty and transparency for parties to reorganization proceedings.

- *Majority within a particular class*

528. No change.

- *Majority of classes*

529. Revise the last two sentences as follows:

Other laws provide that support by classes of unsecured creditors cannot amount to approval of the plan if secured creditors oppose the plan. Requirements for binding dissenting classes are discussed further under 7 and 8 below.

**6. Where a proposed plan cannot be approved**

**(a) Modification of a proposed plan**

530. No change.

**(b) Failure to approve a plan**

531. No change.

**7. Binding dissenting classes of creditors**

532. Add the following after the third sentence:

These conditions include that the requisite approvals of the plan have been obtained and that the approval process was properly conducted; that creditors will receive at least as much under the plan as they would have received in liquidation proceedings; that the plan does not include provisions contrary to the insolvency law or to other relevant law; that administrative claims and expenses will be paid in full except to the extent that the holder of such a claim or expense has agreed to different treatment; that the claims of classes of creditors that do not support a plan are treated under the plan in accordance with the rank accorded to them under the insolvency law (in other words, that creditors in that class will be paid in full, whether in money or property, such as stock or other securities, before a junior rank is paid).

532A. Insert the third and fourth sentences from paragraph 516.

**8. Court confirmation of a plan**

533. No change.

**(a) Challenges to approval of the plan**

534-536. No change.

**(b) Steps required for court confirmation**

537. Add the words "As noted above in paragraph 532" to the beginning of the fourth sentence.

538. No change.

539. Revise the second sentence as follows:

It is highly desirable, in particular, that the law does not provide for the court to review the economic and commercial basis of the decision of creditors (including issues of fairness that do not relate to the approval procedure, but rather to the substance of what has been agreed) nor that it be asked to review particular aspects of the plan in terms of their economic feasibility, unless the circumstances in which this power can be exercised are narrowly defined or the court has the competence and experience to exercise the necessary level of commercial and economic judgement.

**9. Effect of an approved [and confirmed] plan**

540. No change.

**10. Challenges to a plan after court confirmation**

541. Add the following words to the end of the last sentence: “and the extent to which the grounds upon which the plan was successfully challenged can be addressed.”

**11. Amendment of a plan after approval by creditors**

542-4. No change.

**12. Implementation of a plan**

545. No change.

**13. Where implementation fails**

546-7. No change.

**14. Conversion to liquidation**

548. Add the following words at the end of the second sentence as a further ground for conversion: “or failure of implementation for some other reason.”

Add the following at the end of the paragraph: “Consideration may need to be given to the procedural requirements for commencement and conduct of those converted proceedings.”

549-50. No change.

**Recommendations**

**Contents of legislative provisions**

*Preparation of the plan—timing*

(123)(a) The insolvency law should specify that a plan may be proposed on or after the making of an application to commence insolvency proceedings, or within a specified time period after commencement of the insolvency proceedings:

(i)-(ii) No change.

(b) The insolvency law should also address the time limits for proposal of a plan where liquidation proceedings are converted to reorganization proceedings.

*Preparation of a disclosure statement*

(126) The insolvency law should require a plan submitted for the consideration of [those] creditors and equity holders [entitled to vote on approval] to be accompanied by a disclosure statement that will enable an informed decision about the plan to be made. The statement should be prepared by the same party that proposes the plan.

*Submission of the plan and disclosure statement*

(127) The insolvency law should provide a mechanism for submission of the plan and disclosure statement to [those] creditors and equity holders entitled to vote on approval of the plan.

*Content of disclosure statement*

(129) The insolvency law should specify that the disclosure statement include:<sup>92</sup>

- (a) A detailed description of the plan;
- (b) Information relating to the financial situation of the debtor including assets, liabilities and cash flow;
- (c) Non-financial information that might have an impact on the future performance of the debtor; (e.g. the availability of a new patent)
- (d) A comparison of the treatment afforded to creditors by the plan and what they would otherwise receive in liquidation;
- (e) The basis upon which the business would be able to keep trading and could be successfully reorganized;
- (f) Information showing that, having regard to the effect of the plan, [the assets of the debtor will exceed its liabilities] [and that adequate provision has been made for satisfaction of all obligations provided for in the plan]; and
- (g) Information on the voting mechanisms applicable to approval of the plan.

*Content of the plan*

(128) The insolvency law should specify the minimum contents of a plan. The plan should:

- (a) Identify each class of creditors and the treatment provided for each class by the plan (e.g. how much they will receive and the timing of payment [if any]);

<sup>92</sup> Where the insolvency representative does not prepare, or is not involved in the preparation of, the plan and the statement, the insolvency representative should be required to comment on both instruments. Information included in the disclosure statement should be subject to the obligations of confidentiality discussed in paras. ... and recommendation 96.

- [(b) Detail the treatment of equity holders;]
- [(c) Detail the treatment of statutory claims that cannot be modified under the plan;<sup>91a</sup>]
- (d) Detail the terms and conditions of the plan;
- (e) Identify the debtor's role in implementation of the plan;
- (f) Identify those responsible for future management of the debtor and supervision of the implementation of the plan [and indicate their affiliation with the debtor and their remuneration]; and
- (g) Indicate how the plan will be implemented.

#### *Voting mechanisms*

(130) Delete the last sentence – see recommendation 142.

[(130A) The insolvency law should specify that a creditor whose rights are modified by the plan should not be bound to the terms of the plan unless that creditor has been the given [the] [a reasonable] opportunity to vote.]

[(130B) The insolvency law should specify that where the plan provides that the rights of a creditor or class of creditors are not modified or adversely affected by a plan, that creditor or class of creditors is not entitled to vote on approval of the plan.]

[(130C) If the insolvency law specifies that secured or priority creditors can be bound to the terms of the plan, the insolvency law should also specify that those creditors [vote in [one or more] classes that are separate] [shall be separately classified by category and shall vote by class separately] from unsecured creditors without priority.]

[(130D) The insolvency law should specify that all creditors in a class should be offered the same [treatment] [menu of terms].

#### *Approval by classes*

(133) Where voting on approval of the plan is conducted by reference to classes [whose rights will be modified by the plan], the insolvency law should specify how the vote achieved in each class would be treated for the purposes of approval of the plan. Different approaches may be taken, including requiring [approval by all classes or] approval by a specified majority of the classes, [but at least one class of creditors whose rights are modified must approve the plan.]

(134) Where the insolvency law does not require approval by all classes [whose rights will be modified by the plan], the insolvency law should address the treatment of those classes that do not vote to support a plan that is otherwise approved by the requisite classes [consistent with the grounds set forth in recommendation (138)(a)-(e)].

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<sup>91a</sup> [For public policy reasons, some States do not permit claims such as tax claims and some claims arising from employee entitlements to be modified in insolvency. See paras. 291, 633-635 and recommendation 172.]

*Failure to approve a plan*

(135) Deleted – see recommendations 142 and 145.

*Continuing use of encumbered assets*

(137) Deleted.

*Confirmation of an approved plan*

(138) Where the insolvency law requires court confirmation of an approved plan, the court should confirm the plan if the following conditions are satisfied:

(a) [The requisite approvals have been obtained and] the approval process was properly conducted;

(b) Creditors will receive [at least as much under the plan] [economic value worth at least as much, calculated as at the effective date of the plan,] as they would have received in liquidation, unless they have specifically agreed to receive lesser treatment;

(c) The plan does not contain provisions contrary to the law;

(d) Administrative claims and expenses will be paid in full except to the extent that the holder of the claim or expense agrees to different treatment; and

(e) [Except to the extent that [affected creditors or] [classes of creditors whose rights are modified by the plan] have agreed [otherwise,<sup>94</sup>] the treatment of [creditor] claims<sup>93</sup> in the plan conforms to the ranking of [creditor] claims under the insolvency law.] [The treatment accorded under the plan to the claims of a class of creditors that has voted against the plan, conforms to ranking of that class of claims under the insolvency law.]

*Challenges to approval (where there is no requirement for confirmation)*

(139) Where a plan becomes binding on approval by creditors, without requiring confirmation by the court, the insolvency law should permit interested parties, including the debtor, to challenge the approval of the plan. The insolvency law should specify criteria against which a challenge can be assessed which should include:

(a) Whether the grounds set forth in recommendation (138) are satisfied; and

(b) Fraud, in which case the requirements of recommendation (140)(a)-(c) should apply.

*Challenges to a confirmed plan*

(140) The insolvency law should permit a confirmed plan to be challenged on the basis of fraud. The insolvency law should specify:

(a)-(b) No change.

(c) That the challenge should be heard by the court.

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<sup>94</sup> Including claims for administrative costs and expenses.

<sup>93</sup> The court should satisfy itself that if one or more creditors are to receive less favourable treatment than prescribed for their rank under the insolvency law, those creditors have consented to that treatment.



*Amendment of the plan*

(142) The insolvency law should permit amendment of a plan and specify the parties that may propose amendments and the time at which the plan may be amended [including between submission and approval, approval and confirmation, after confirmation and during implementation, where the proceedings remain open.]

*Approval of amendments*

(143) The insolvency law should establish the mechanism for approval of amendments to the plan. [Where amendment occurs after the plan has been approved by creditors,] that mechanism should require notice to be given to the creditors and other parties [affected by the modification]; specify the party required to give notice; require the approval of creditors and other parties [affected by the modification] and satisfaction of the rules for confirmation (where confirmation is required). The insolvency law should also specify the consequences of failure to secure approval of proposed amendments.

*Supervision of implementation*

(144) No change.

*Conversion to liquidation*

(145) The insolvency law should provide that the court may convert reorganization proceedings to liquidation where:

- (a) A plan is not proposed within any time limit specified by the law and no extension of time is approved by the court;
- (b) An application for conversion is made by the insolvency representative or creditors;
- (c) A proposed plan is not approved;
- (d) An approved plan is not confirmed (where the law requires confirmation);
- (e) An approved or a confirmed plan is successfully challenged; or
- (f) There is substantial breach [by the debtor] of the terms of the plan [or implementation of the plan fails for other reasons].<sup>95a</sup>

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<sup>95a</sup> [This course of action is only available where the proceedings remain open during implementation.]

## **B. Expedited reorganization proceedings<sup>96a</sup>**

### **1. Introduction**

551. As discussed above in part one of the Guide, reorganization can take one of several forms. These include informal (i.e. in the sense of being conducted out-of-court) voluntary restructuring negotiations which require little or no court involvement and essentially depend upon the agreement of the parties involved and reorganization proceedings conducted under the formal supervision of a court. These formal proceedings generally involve all creditors of the debtor and a reorganization plan formulated and approved by creditors and other interested parties after commencement of the proceedings. Reorganization may also include, however, proceedings commenced to give effect to a plan negotiated and agreed by affected creditors in voluntary restructuring negotiations that take place prior to commencement, where the insolvency law permits the court to expedite the conduct of those proceedings (referred to in this section as expedited reorganization proceedings).

551A. Because many of the costs, delays and procedural and legal requirements of formal reorganization proceedings can be avoided where voluntary restructuring negotiations and expedited reorganization proceedings are used, this often can be the most cost efficient means of resolving a debtor's financial difficulties, although it may not be effective in all instances of financial difficulty because it depends upon certain pre-conditions, discussed in part one of the Guide. These may include that a significant amount of debt is owed to a limited number of main banks or financial institution creditors; acceptance amongst creditors of the view that it may be preferable to negotiate an arrangement, as between the debtor and the financiers and also between the financiers themselves, to resolve the financial difficulties of the debtor; the prospect that there may be a greater benefit for all parties through the negotiation process than by direct and immediate resort to the insolvency law (in part because the outcome is subject to the control of the negotiating parties and the process is less expensive and can be accomplished quickly without disrupting the debtor's business); and that the debtor does not need relief from trade debts, or the benefits of formal insolvency, such as the automatic stay or the ability to reject burdensome debts.

551B. Notwithstanding the dependence upon such conditions, voluntary restructuring negotiations and expedited reorganization proceedings can be valuable tools in the range of insolvency solutions available to a country's commercial and business sector. Encouraging the use of such solutions need not stem from the fact that a country's formal insolvency system is poor, inefficient or unreliable, but rather from the advantages such solutions can offer as an adjunct to a purely formal insolvency proceedings which deliver fairness and certainty. Moreover, such solutions work best where there is the possibility that if the negotiation process cannot be started or breaks down, there can be swift and effective resort to the insolvency law.

552. Add the words "To provide a negotiating framework that can be agreed by all participants and facilitates" to the beginning of the third sentence.

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<sup>96a</sup> Because these proceedings are based on the agreement achieved in voluntary restructuring negotiations, this section should be read in conjunction with part one, chapter II.A.

553. Revise the third sentence and following:

Under most existing legal systems, such a modification of contractual rights requires the commencement of full court-supervised reorganization proceedings under the insolvency law, involving all creditors and satisfaction of the requirements of the insolvency law governing the conduct of those proceedings. Timing is typically critical in business restructuring and delay (usually inherent in full court-supervised insolvency proceedings) can frequently be costly or even fatal to achieving an effective solution.

## **2. Creditors typically involved in voluntary restructuring negotiations**

554. No change.

555. The limited classes of creditors that would normally participate in voluntary restructuring negotiations make an agreement easier to accomplish than full court-supervised reorganization because the latter proceedings typically affect all claims. Since it is usual in voluntary restructuring negotiations for certain types of non-institutional and other creditors, such as trade creditors, to continue to be paid in the ordinary course of business. These creditors are not likely to have any objection to the proposed restructuring and they do not need to participate in the negotiations. Where, however, the rights of those creditors are to be modified by the restructuring plan, their agreement to the proposed modifications would be required.

## **3. Proceedings to implement a voluntary restructuring agreement**

556. An insolvency law can include in provisions on commencement of reorganization proceedings under the insolvency law, provisions for the recognition of a voluntary restructuring agreement and allowing expedition of those proceedings. Where it does so, consideration will need to be given to defining the debtors to whom such provisions might apply and the parties that can be affected by such expedited proceedings.

### **(a) Eligible debtors**

557. Expedited reorganization proceedings may be available on the application of any debtor eligible to commence proceedings under the general reorganization provisions of an insolvency law on the basis that it is likely to be generally unable to pay its debts as they mature.

558. No change

### **(b) Obligations affected**

559. Revise the last sentence as follows:

The specific obligations to be affected in any given case would be those identified in the plan which is to be recognized under expedited proceedings.

### **(c) Application of the insolvency law**

560. Revise the first and second sentences as follows:

An insolvency law that permits expedited proceedings will need to identify those provisions of the insolvency law applicable to full court-supervised proceedings that will apply to these proceedings, particularly if any changes

are to be made in the manner in which they apply. So, for example, the provisions which would generally apply to this type of proceedings in the same manner as for full court-supervised proceedings (unless specifically modified) might include provisions on: application procedures; commencement; application of the stay; requirements for preparation of a list of all creditors (in order to inform the court, and provide certainty as to who is affected by the plan and who is not); requirements for approval of the plan (including provision of the plan and supporting information to affected creditors, determination of classes of creditors, creditor committees, criteria and majorities required for approval); effect and confirmation of the plan, including standards of treatment that protect the interests of dissenting creditors; issues relating to implementation of the plan and discharge of claims.

561. Revise the first sentence as follows:

Provisions of the insolvency law that might not apply to expedited proceedings would include those relating to the appointment of the insolvency representative, unless the plan specifically provides for that appointment; submission of claims; requirements for notice and time periods for plan approval (where such provisions are included in the insolvency law); and voting on the plan (since this occurred before commencement).

562. No change.

**(d) Expedition of the proceedings**

563. Revise the first sentence as follows:

In order to take full advantage of the negotiated agreement and avoid the delays that may make that agreement impossible to implement, an insolvency law may need to consider how, in addition to recognizing the steps that have been completed before commencement as noted above, expedited proceedings can be handled more quickly than full court-supervised reorganization proceedings.

Revise the fourth sentence as follows:

For example, if a plan has been negotiated and agreed to by a majority of creditors of a particular class—typically the institutional creditors—sufficient to satisfy the voting requirements of the insolvency law for approval of a reorganization plan and the rights of other creditors will not be impaired by the plan, it might be possible for the court to order a meeting or hearing of that particular approving class of creditors only.

564. Revise the first sentence as follows:

Even where the insolvency law provides for eligible cases to be treated expeditiously, it is highly desirable that it does not afford less protection for dissenting creditors and other parties than the insolvency law provides for dissenting creditors and other parties in full court-supervised reorganization proceedings.

565. Other laws may need to be modified to encourage or accommodate both voluntary restructuring negotiations and expedited reorganization proceedings.

Examples of such laws might include those that expose directors to liability for trading during the conduct of voluntary restructuring negotiations; that do not recognize obligations for credit extended during such a period or subject those obligations to avoidance provisions; and that restrict conversion of debt to equity.

## **Recommendations**

### **Content of legislative provisions**

#### *Commencement of expedited reorganization proceedings*

(146) The insolvency law should specify that expedited proceedings can be commenced on the application of any debtor that:

- (a) Is likely to be generally unable to pay its debts as they mature;
- (b) Has negotiated a reorganization plan and had it accepted by each affected class of creditors and by each affected creditor not part of a voting class; and
- (c) No change.

#### *Application requirements*

(147) The insolvency law should specify that the following additional materials should accompany an application for commencement of expedited reorganization proceedings:

- (a) The reorganization plan and disclosure statement;
- (b) A description of the voluntary restructuring negotiations that preceded the making of the application for commencement, including the information provided to affected creditors to enable them to make an informed decision about the plan;
- (c) Certification that unaffected creditors are being paid in the ordinary course of business and that the plan does not modify or impair the rights or claims of preferential creditors, such as tax or social security authorities or employees, [without their agreement] [unless they have had an opportunity to vote on the plan];
- (d) No change;
- (e) A financial analysis or other evidence which demonstrates that the plan satisfies all applicable requirements for reorganization; and
- (f) A list of the members of any creditor committee formed during the course of the voluntary restructuring negotiations.

#### *Commencement*

(148) The insolvency law should specify that the application for commencement will automatically commence the proceedings or that the court will be required to promptly determine whether the debtor satisfies the requirements of recommendation 146 and if so, commence proceedings.

*Effect of commencement*

(149) The insolvency law should specify that:

(a) Provisions of the insolvency law that apply to full reorganization proceedings will also apply to expedited proceedings unless specified as not applicable;<sup>98</sup>

(b) Unless otherwise determined by the court the effects of commencement should be limited to the debtor, individual creditors and classes of creditors and shareholders whose rights are modified or who are affected by the plan;

(c) No change; and

(d) A hearing on the confirmation of the plan by the court should be held as expeditiously as possible.

*Notice of commencement*

(150) The insolvency law should specify that notice of the commencement of expedited proceedings be given to [affected] creditors and [affected] equity holders using existing available means. The notice should specify:

(a)-(d) No change; and

(e) The impact of the plan on equity holders.

*Confirmation of the plan*

(151) The insolvency law should specify that the court will confirm the plan if:

(a) The plan satisfies the substantive requirements for confirmation of a plan in full reorganization proceedings, in so far as those requirements apply to affected creditors and affected equity holders;

(b) The notice given and the information provided to affected creditors and affected equity holders during the voluntary restructuring negotiations was sufficient to enable them to make an informed decision about the plan and any pre-commencement solicitation of acceptances to the plan complied with applicable law;

(c) Unaffected creditors are being paid in the ordinary course of business and the plan does not modify or impair the rights or claims of priority creditors, such as tax or social security authorities or employees, without their agreement [unless they have had the opportunity to vote on the plan]; and

(d) No change.

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<sup>98</sup> Provisions of the insolvency law that generally would not be applicable would include: full claim filing; notice and time periods for plan approval; the post-commencement mechanics of providing the plan and disclosure statement to creditors and other interested parties and for solicitation of votes and voting on the plan; appointment of an insolvency representative (who generally would not be appointed unless required by the plan); provisions on amendment of the plan after confirmation. An exception to the provisions of the insolvency law applicable to full reorganization proceedings would be that creditors not affected by the plan would be paid in the ordinary course of business during the implementation of the plan

*Effect of a confirmed plan*

(152) The insolvency law should specify that the effect of a plan confirmed by the court should be limited to the debtor and those creditors and equity holders affected by the plan.

*Failure of implementation of a confirmed plan*

(153) The insolvency law should specify that where there is a substantial breach of the terms of the plan confirmed by the court in accordance with recommendation (151), the proceedings may be closed and creditors may exercise their rights at law.





## II. INTERNATIONAL COMMERCIAL ARBITRATION AND CONCILIATION

### A. Report of the Working Group on Arbitration on the work of its thirty-ninth session (Vienna, 10-14 November 2003)

(A/CN.9/545) [Original: English]

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## I. Introduction

1. At its thirty-second session, in 1999, the Commission had before it a note entitled “Possible future work in the area of international commercial arbitration” (A/CN.9/460). Welcoming the opportunity to discuss the desirability and feasibility of further development of the law of international commercial arbitration, the Commission generally considered that the time had come to assess the extensive and favourable experience with national enactments of the UNCITRAL Model Law on International Commercial Arbitration (1985), as well as the use of the UNCITRAL Arbitration Rules and the UNCITRAL Conciliation Rules, and to evaluate in the universal forum of the Commission the acceptability of ideas and proposals for improvement of arbitration laws, rules and practices.<sup>1</sup>

2. The Commission entrusted the work to one of its working groups, which it established as Working Group II (Arbitration), and decided that the priority items for the Working Group should be conciliation,<sup>2</sup> requirement of written form for the arbitration agreement,<sup>3</sup> enforceability of interim measures of protection<sup>4</sup> and possible enforceability of an award that had been set aside in the State of origin.<sup>5</sup>

<sup>1</sup> *Official Records of the General Assembly, Fifty-fourth Session, Supplement No. 17 (A/54/17)*, para. 337.

<sup>2</sup> *Ibid.*, paras. 340-343.

<sup>3</sup> *Ibid.*, paras. 344-350.

<sup>4</sup> *Ibid.*, paras. 371-373.

<sup>5</sup> *Ibid.*, paras. 374 and 375.

3. At its thirty-third session, in 2000, the Commission had before it the report of the Working Group on Arbitration on the work of its thirty-second session (A/CN.9/468). The Commission took note of the report with satisfaction and reaffirmed the mandate of the Working Group to decide on the time and manner of dealing with the topics identified for future work. Several statements were made to the effect that, in general, the Working Group, in deciding the priorities of the future items on its agenda, should pay particular attention to what was feasible and practical and to issues where court decisions left the legal situation uncertain or unsatisfactory. Topics that were mentioned in the Commission as potentially worthy of consideration, in addition to those which the Working Group might identify as such, were the meaning and effect of the more-favourable-right provision of article VII of the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (hereinafter referred to as “the New York Convention”) (A/CN.9/468, para. 109 (k)); raising claims in arbitral proceedings for the purpose of set-off and the jurisdiction of the arbitral tribunal with respect to such claims (*ibid.*, para. 107 (g)); freedom of parties to be represented in arbitral proceedings by persons of their choice (*ibid.*, para. 108 (c)); residual discretionary power to grant enforcement of an award notwithstanding the existence of a ground for refusal listed in article V of the 1958 New York Convention (*ibid.*, para. 109 (i)); and the power by the arbitral tribunal to award interest (*ibid.*, para. 107 (j)). It was noted with approval that, with respect to “online” arbitrations (i.e. arbitrations in which significant parts or even all of arbitral proceedings were conducted by using electronic means of communication) (*ibid.*, para. 113), the Working Group on Arbitration would cooperate with the Working Group on Electronic Commerce. With respect to the possible enforceability of awards that had been set aside in the State of origin (*ibid.*, para. 107 (m)), the view was expressed that the issue was not expected to raise many problems and that the case law that gave rise to the issue should not be regarded as a trend.<sup>6</sup>

4. At its thirty-fourth session, in 2001, the Commission took note with appreciation of the reports of the Working Group on the work of its thirty-third and thirty-fourth sessions (A/CN.9/485 and A/CN.9/487, respectively). The Commission commended the Working Group for the progress accomplished so far regarding the three main issues under discussion, namely, the requirement of the written form for the arbitration agreement, the issues of interim measures of protection and the preparation of a model law on conciliation.<sup>7</sup>

5. At its thirty-fifth session, in 2002, the Commission adopted the UNCITRAL Model Law on International Commercial Conciliation and took note with appreciation of the report of the Working Group on the work of its thirty-sixth session (A/CN.9/508). The Commission commended the Working Group for the progress accomplished so far regarding the issues under discussion, namely, the requirement of the written form for the arbitration agreement and the issues of interim measures of protection.

6. With regard to the requirement of written form for the arbitration agreement, the Commission noted that the Working Group had considered the draft model

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<sup>6</sup> *Ibid.*, *Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 396.

<sup>7</sup> *Ibid.*, *Fifty-sixth Session, Supplement No. 17* (A/56/17), paras. 312-314.

legislative provision revising article 7, paragraph (2), of the UNCITRAL Model Law on International Commercial Arbitration (see A/CN.9/WG.II/WP.118, para. 9) and discussed a draft interpretative instrument regarding article II, paragraph 2, of the New York Convention (*ibid.*, paras. 25-26). The Commission noted that the Working Group had not reached consensus on whether to prepare an amending protocol or an interpretative instrument to the New York Convention and that both options should be kept open for consideration by the Working Group or the Commission at a later stage. The Commission noted the decision of the Working Group to offer guidance on interpretation and application of the writing requirements in the New York Convention with a view to achieving a higher degree of uniformity. A valuable contribution to that end could be made in the guide to enactment of the draft new article 7 of the UNCITRAL Model Law on Arbitration, which the Secretariat was requested to prepare for future consideration by the Working Group, by establishing a “friendly bridge” between the new provisions and the New York Convention, pending a final decision by the Working Group on how best to deal with the application of article II (2) of the Convention (A/CN.9/508, para. 15). The Commission was of the view that member and observer States participating in the Working Group’s deliberations should have ample time for consultations on those important issues, including the possibility of examining further the meaning and effect of the more-favourable-right provision of article VII of the New York Convention, as noted by the Commission at its thirty-fourth session. For that purpose, the Commission considered that it might be preferable for the Working Group to postpone its discussions regarding the requirement of written form for the arbitration agreement and the New York Convention.

7. With regard to the issues of interim measures of protection, the Commission noted that the Working Group had considered a draft text for a revision of article 17 of the Model Law (A/CN.9/WG.II/WP.119, para. 74) and that the Secretariat had been requested to prepare revised draft provisions, based on the discussion in the Working Group, for consideration at a future session. It was also noted that a revised draft of a new article prepared by the Secretariat for addition to the Model Law regarding the issue of enforcement of interim measures of protection ordered by an arbitral tribunal (*ibid.*, para. 83) would be considered by the Working Group at its thirty-seventh session (A/CN.9/508, para. 16).<sup>8</sup>

8. At its thirty-seventh session (Vienna, 7-11 October 2002), the Working Group discussed the issue of interim measures ordered by the arbitral tribunal on the basis of a proposal by the United States of America (A/CN.9/WG.II/WP.121) and a note prepared by the Secretariat (A/CN.9/WG.II/WP.119). The Working Group also had a brief discussion on the issue of recognition and enforcement of interim measures based on the note prepared by the Secretariat. In that connection, another drafting proposal was made by the United States (A/CN.9/523, paras. 14, 78 and 79).

9. At its thirty-eighth session (New York, 12-16 May 2003), the Working Group discussed the issue of recognition and enforcement of interim measures issued by an arbitral tribunal and also considered a draft provision expressing the power of the court to order interim measures of protection in support of arbitration. The Secretariat was requested to prepare a revised text setting out the various options discussed by the Working Group.

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<sup>8</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17* (A/57/17), paras. 182-184.

10. At its thirty-sixth session (Vienna, 30 June-11 July 2003), the Commission agreed that it was unlikely that all the topics, namely, the written form for arbitration agreements and the various issues to be considered in the area of interim measures of protection, could be finalized by the Working Group before the thirty-seventh session of the Commission in 2004. It was the understanding of the Commission that the Working Group would give a degree of priority to interim measures of protection and the Commission noted the suggestion that the issue of *ex parte* interim measures, which the Commission agreed remained a point of controversy, should not delay progress on that topic.<sup>9</sup>

11. The Working Group on Arbitration which was composed of all States members of the Commission, held its thirty-ninth session in Vienna, from 10 to 14 November 2003. The session was attended by the following States members of the Working Group: Austria, Brazil, Canada, China, Colombia, France, Germany, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Lithuania, Mexico, the Russian Federation, Singapore, Spain, Sweden, Thailand, the United Kingdom of Great Britain and Northern Ireland, the United States of America and Uruguay.

12. The session was attended by observers from the following States: Albania, Algeria, Argentina, Australia, Costa Rica, Croatia, Cuba, Cyprus, Denmark, Finland, Ireland, Kuwait, Lebanon, Nigeria, Pakistan, Panama, Peru, Poland, Qatar, the Republic of Korea, Slovakia, Switzerland, Turkey, Ukraine, Venezuela, Yemen and Zimbabwe.

13. The session was also attended by observers from the following intergovernmental organizations: Hague Conference on Private International Law (HCCH), International Union of Latin Notaries (UILN), NAFTA Article 2022 Advisory Committee and Permanent Court of Arbitration (PCA).

14. The session was also attended by observers from the following international non-governmental organizations invited by the Commission: American Arbitration Association (AAA), Arab Union of International Arbitration, Cairo Regional Centre for International Commercial Arbitration, Center for International Legal Studies (CILS), *Conseil des Barreaux de l'Union Européenne (CCBE)*, International Council for Commercial Arbitration (ICCA), International Court of Arbitration of the Chamber of Commerce (ICC), Moot Alumni Association, Regional Centre for Arbitration Kuala Lumpur, School of International Arbitration, The Chartered Institute of Arbitrators, the Club of Arbitrators, and The European Law Student's Association (ELSA).

15. The Working Group elected the following officers:

*Chairman:* Mr. José María ABASCAL ZAMORA (Mexico);

*Rapporteur:* Mrs. Vilawan MANGKLATANAKUL (Thailand).

16. The Working Group had before it the following documents: (a) provisional agenda (A/CN.9/WG.II/WP.124); (b) a note by the Secretariat containing a revised text of a draft provision on the power of an arbitral tribunal to order interim

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<sup>9</sup> *Ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 203.

measures (A/CN.9/WG.II/WP.123); (c) a newly revised draft provision on enforcement and recognition of interim measures of protection pursuant to the decisions made by the Working Group at its thirty-eighth session (A/CN.9/WG.II/WP.125); (d) the report of the Working Group on its thirty-seventh and thirty-eighth sessions (A/CN.9/523 and 524).

17. The Working Group adopted the following agenda:

1. Scheduling of meetings.
2. Election of officers.
3. Adoption of the agenda.
4. Preparation of uniform provisions on interim measures of protection for inclusion in the UNCITRAL Model Law on International Commercial Arbitration.
5. Other business.
6. Adoption of the report.

## **II. Summary of deliberations and decisions**

18. The Working Group discussed agenda item 4 on the basis of the text contained in the notes prepared by the Secretariat (A/CN.9/WG.II/WP.123 and 125). The deliberations and conclusions of the Working Group with respect to that item are reflected in chapters III and IV below. The Secretariat was requested to prepare a revised draft of a number of provisions, based on the deliberations and conclusions of the Working Group.

## **III. Revised draft of article 17 of the UNCITRAL Model Law on International Commercial Arbitration on the power of an arbitral tribunal to grant interim measures of protection**

19. The text of draft article 17 as considered by the Working Group was as follows:

“(1) Unless otherwise agreed by the parties, the arbitral tribunal may, at the request of a party, grant interim measures of protection.

“(2) An interim measure of protection is any temporary measure, whether in the form of an award or in another form, by which, at any time prior to the issuance of the award by which the dispute is finally decided, the arbitral tribunal orders a party to:

(a) Maintain or restore the status quo pending determination of the dispute [, in order to ensure or facilitate the effectiveness of a subsequent award];

(b) Take action that would prevent, or refrain from taking action that would cause, current or imminent harm [, in order to ensure or facilitate the effectiveness of a subsequent award];

(c) Provide a preliminary means of securing assets out of which a subsequent award may be satisfied; or

[(d) Preserve evidence that may be relevant and material to the resolution of the dispute.]

“(3) The party requesting the interim measure of protection shall [demonstrate] [show] [prove] [establish] that:

(a) Irreparable harm will result if the measure is not ordered, and such harm substantially outweighs the harm that will result to the party affected by the measure if the measure is granted; and

(b) There is a reasonable possibility that the requesting party will succeed on the merits, provided that any determination on this possibility shall not affect the discretion of the arbitral tribunal in making any subsequent determinations.

“(4) [Subject to paragraph (7)(b)(ii),] [except where the provision of a security is mandatory under paragraph (7)(b)(ii),] the arbitral tribunal may require the requesting party and any other party to provide appropriate security as a condition to granting an interim measure of protection.

“(5) The arbitral tribunal may modify or terminate an interim measure of protection at any time [in light of additional information or a change of circumstances].

“(6) The requesting party shall, from the time of the request onwards, inform the arbitral tribunal promptly of any material change in the circumstances on the basis of which the party sought or the arbitral tribunal granted the interim measure of protection.

“(7) (a) Unless otherwise agreed by the parties, the arbitral tribunal may [, in exceptional circumstances,] grant an interim measure of protection, without notice to the party [against whom the measure is directed] [affected by the measure], when:

(i) There is an urgent need for the measure;

(ii) The circumstances set out in paragraph (3) are met; and

(iii) The requesting party shows that it is necessary to proceed in that manner in order to ensure that the purpose of the measure is not frustrated before it is granted;

(b) The requesting party shall:

(i) Be liable for any costs and damages caused by the measure to the party [against whom it is directed] [affected by the measure] [to the extent appropriate, taking into account all of the circumstances of the case, in light of the final disposition of the claims on the merits]; and

(ii) Provide security in such form as the arbitral tribunal considers appropriate [, for any costs and damages referred to under subparagraph (i),] [as a condition to granting a measure under this paragraph];

[(c) [For the avoidance of doubt,] the arbitral tribunal shall have jurisdiction, inter alia, to determine all issues arising out of or relating to [subparagraph (b)], above;]

[(d) The party [against whom the interim measure of protection is directed] [affected by the measure granted] under this paragraph shall be given notice of the measure and an opportunity to be heard by the arbitral tribunal [as soon as it is no longer necessary to proceed on an *ex parte* basis in order to ensure that the measure is effective] [within forty-eight hours of the notice, or on such other date and time as is appropriate in the circumstances];]

[(e) Any interim measure of protection ordered under this paragraph shall be effective for no more than twenty days [from the date on which the arbitral tribunal orders the measure] [from the date on which the measure takes effect against the other party], which period cannot be extended. This subparagraph shall not affect the authority of the arbitral tribunal to grant, confirm, extend, or modify an interim measure of protection under paragraph (1) after the party [against whom the measure is directed] [affected by the measure] has been given notice and an opportunity to be heard;]

[(f) A party requesting an interim measure of protection under this paragraph shall have an obligation to inform the arbitral tribunal of all circumstances that the arbitral tribunal is likely to find relevant and material to its determination whether the requirements of this paragraph have been met;]”

#### **Paragraph (1)**

20. The Working Group found the substance of paragraph (1) to be generally acceptable.

#### **Paragraph (2)**

##### *Exhaustive nature of the list of functions characteristic of interim measures*

21. The Working Group recalled that, at its thirty-seventh session, it had agreed that it should be made abundantly clear that the list of provisional measures provided in the various subparagraphs was intended to be non-exhaustive (A/CN.9/508, para. 71). The Working Group noted that, as redrafted, the list appeared exhaustive. The Working Group proceeded to consider whether all conceivable grounds for which an interim measure of protection might need to be granted were covered by the current formulation. It was suggested that a subparagraph could be added to leave open the possibility that an arbitral tribunal might order an interim measure in exceptional circumstances not currently covered by paragraph (2). Although some support was expressed for that suggestion, it was widely felt that the suggested addition was unnecessary. It was recalled that the paragraph, as previously drafted, attempted to list all types of interim measures, whereas the current draft provided generic broadly cast categories describing the functions or purposes of various interim measures without focusing on specific measures. The current draft thus provided a flexible approach covering all possible circumstances in which an interim measure might be sought. It was also pointed out that an exhaustive generic list was preferable because it provided clarity in respect of the powers of the arbitral tribunal and might reassure courts at the point of



recognition or enforcement of an interim measure. After discussion, the Working Group agreed that, to the extent that all the purposes for interim measures were generically covered by the revised list contained in paragraph (2), it was no longer necessary to make that list non-exhaustive.

Subparagraphs (a) and (b)

*“[in order to ensure or facilitate the effectiveness of a subsequent award]”*

22. It was suggested that the bracketed text in both subparagraphs (a) and (b) namely “in order to ensure or facilitate the effectiveness of a subsequent award” should be deleted. In support of that suggestion, it was said that paragraph (2) provided a definition of an interim measure rather than the conditions required to order an interim measure which were set out in paragraph (3) of the draft article. It was said that retaining the bracketed text in subparagraphs (a) and (b) could be read as imposing an additional condition to be met before an interim measure could be granted. In addition, it was said that there might be circumstances where an interim measure could be sought for purposes other than to ensure or facilitate the effectiveness of a subsequent award, for example where a party sought an interim measure preventing one party from aggravating the dispute by initiating proceedings in another forum. The Working Group agreed that the bracketed text in subparagraphs (a) and (b) should be deleted.

*“maintain or restore the status quo”*

23. A suggestion was made that subparagraphs (a) and (b) should be merged since the need to maintain or restore the status quo should only be regarded as a subcategory of a broader set of circumstances where an interim measure would be necessary to preclude harm to the party seeking such interim measure. A more fundamental question was raised as to whether preservation or restoration of the status quo should be regarded as a natural function of an arbitral tribunal in the absence of any of the circumstances covered by subparagraph (b). However, it was strongly felt that it was necessary to maintain subparagraph (a), which set out the concept of maintaining the status quo, since that concept was well-established and understood in many systems as one purpose of an interim measure.

*“current or imminent harm”*

24. The view was expressed that, if the Working Group agreed to the deletion of the bracketed text in subparagraph (b), this would leave a very broad definition referring to “harm” without any indication as to the nature of such harm or the person that would be harmed. It was suggested that this could lead to arbitral tribunals making orders for interim measures that would not be upheld by courts and also could encourage arguments regarding what harm was required before the enforcement court. After discussion, however, the Working Group agreed that, while there was undoubtedly some overlap between subparagraphs (a) and (b), retaining both subparagraphs was unlikely to create harm and might be regarded as particularly helpful in certain legal systems.

25. A question was raised as to whether the words “would cause, current or imminent harm” in subparagraph (b) were appropriate or whether they could create problems of proof given that, at the time an interim measure was sought, there were

often insufficient facts to provide proof that, unless a particular action was taken or refrained from being taken, harm would inevitably result. It was proposed that wording along the lines of “is likely to cause” or “could cause” could address this concern. A number of delegations expressed concern that such a formulation might make the threshold for obtaining an interim measure too low and result in excessive discretion being granted to the arbitral tribunal with respect to the issuance of an interim measure. After discussion, however, the Working Group decided that the words “would cause” should be replaced by wording along the lines of “is likely to cause”.

#### Subparagraph (c)

26. Clarification was sought as to the meaning of subparagraph (c) and in particular as to the use of the phrase “securing assets”. It was said that this term could be incorrectly understood as requiring the giving of a legal guarantee or security. The Working Group agreed that the term merely referred to the securing of assets and should not be interpreted as requiring a legal guarantee or security in all cases. The Working Group generally agreed that the intention in subparagraph (c) was to refer to the preservation of assets. The Working Group took note of the suggestion that the drafting group to be established at a later stage by the Secretariat to ensure consistency between the various linguistic versions should consider the possibility of using wording along the lines of “preserving assets” instead of “securing assets”. The Working Group also took note of a suggestion that the word “preliminary” in subparagraph (c) was unnecessary, potentially misleading, and should be deleted.

#### Subparagraph (d)

27. The Working Group recalled that subparagraph (d) of the revised draft had not been discussed at the thirty-seventh session. It was agreed that the text contained in subparagraph (d) should be retained in substance and that the brackets should be omitted. While the view was expressed that in certain legal systems subparagraph (d) was superfluous, the text was considered important as the preservation of evidence was not necessarily dealt with to a sufficient extent by all domestic rules of civil procedure.

#### Paragraph (3)

“[*demonstrate*] [*show*] [*prove*] [*establish*]”

28. The Working Group recalled that, at its thirty-eighth session, a concern was expressed that the word “demonstrate” in the opening words of the paragraph might connote a high standard of proof. It was recalled that a similar debate had taken place at the thirty-seventh session of the Working Group and that the verbs “show”, “prove” and “establish” had been suggested together with the verb “demonstrate”, without the Working Group making a decision in that regard (A/CN.9/508, para. 58). At its current session, the Working Group agreed that the chapeau of paragraph (3) should be redrafted in order to better reflect the intention of the Working Group to provide a neutral formulation of the standard of proof. Wording along the following lines was suggested: “The party requesting the interim measure of protection shall satisfy the arbitral tribunal that:”. Broad support was expressed in favour of the suggested wording. As an alternative

drafting suggestion, the words “The party requesting the interim measure of protection shall produce evidence that:” were proposed. A view was expressed that an even more neutral formulation might read along the lines of “The arbitral tribunal is satisfied that”. It was stated in response that, while neutrality in respect of the *standard* of proof was desirable, the provision should clearly establish that the *burden* of convincing the arbitral tribunal that the conditions for issuing an interim measure were met should be borne by the requesting party. After discussion the Working Group decided that the words “The party requesting the interim measure of protection shall satisfy the arbitral tribunal that” should be used.

Subparagraph (a)

*“irreparable harm”*

29. Concerns were raised about the use of the term “irreparable harm”. It was suggested that, in the commercial context, most occurrences could be cured with monetary compensation and the term “irreparable harm” might be too narrow. Alternative proposals were made to refer to “significant”, “exceptional” or “considerable” harm. It was pointed out, however, that the notion of “irreparable harm” was well known in many legal systems and constituted an ordinary pre-requisite for ordering an interim measure. Interim measures of protection were an exceptional form of relief granted when damages might not constitute an adequate alternative remedy. The Working Group agreed that this wording should be retained, possibly with an explanatory note in any accompanying guide to the Model Law as to the meaning of “irreparable harm”. It was acknowledged, however, that the notion of irreparable harm might lend itself to various interpretations. In the view of some delegations, the term should be used only to refer to a truly irreparable damage such as the loss of a priceless work of art. Other delegations referred to the notion of “irreparable damage” as a means of describing particularly serious types of damage that would outweigh the damage that the party against whom the interim measure would be granted could be expected to suffer if that measure was effectively granted. The Working Group noted that the discussion might need to be reopened at a later stage.

*“will result”*

30. The Working Group recalled that, in the context of paragraph (2), it had decided that the draft provision should avoid creating problems of proof that might arise given that, at the time an interim measure was sought, there were often insufficient facts to provide proof that, unless a particular action was taken or refrained from being taken, harm would inevitably result. For that reason, the words “would cause” in paragraph (2) had been replaced by the words “is likely to cause” (see para. 25, above). For a similar reason, it was decided that in subparagraph (a) of paragraph (3), the words “will result” should be replaced by wording along the lines of “is likely to result”.

Subparagraph (b)

*“will succeed”*

31. It was suggested that a similar change should be made to subparagraph (b) in respect of the words “will succeed”, which could be replaced by wording along the

lines of “is likely to succeed”. After discussion, it was generally agreed that the suggested change was unnecessary in view of the fact that the introductory words “There is a reasonable possibility” provided the required level of flexibility.

*“provided that any determination on this possibility shall not affect the discretion of the arbitral tribunal in making any subsequent determinations”*

32. The Working Group considered whether the proviso in subparagraph (b) that “any determination on this possibility shall not affect the discretion of the arbitral tribunal in making any subsequent determinations” should be maintained. It was pointed out that, for the sake of simplifying drafting, this phrase should be deleted and included in an explanatory guide to the Model Law. It was widely felt, however, that the Model Law itself should provide guidance to the arbitrators and give them the necessary level of comfort when they were called upon to decide on the issuance of an interim measure of protection. After discussion, it was agreed that the substance of the proviso should be retained.

#### **Paragraph (4)**

33. This paragraph was based on the idea that, in respect of *inter partes* measures, the possibility of requiring security should be within the discretion of the arbitral tribunal (A/CN.9/523, para. 46). In order to clarify that paragraph (4) was not intended to create a possibility to avoid supplying mandatory security in respect of *ex parte* interim measures of protection (A/CN.9/523, para. 46), two alternative texts had been included in the revised draft in square brackets.

34. The Working Group considered paragraph (4) and agreed that the wording in square brackets was unnecessary and should be deleted, as the remainder of paragraph (4) makes it clear that the arbitral tribunal retains the right, in all circumstances, to require the provision of security as a condition to granting an interim measure of protection.

#### **Paragraph (5)**

*“modify or terminate”*

35. It was suggested that, for the sake of completeness and for better consistency between draft articles 17 and 17 bis, the words “modify or terminate” should be amended to read “modify, suspend or terminate”. The Working Group adopted that suggestion.

*“[in light of additional information or a change of circumstances]”*

36. While some support was expressed for the retention of the words between square brackets (“[in light of additional information or a change of circumstances]”), it was widely felt that those words were superfluous. Among the reasons given for the deletion of those words, it was stated that arbitrators would generally explain in the text of their decision the reasoning they followed when deciding to grant the interim measure. It was also felt that those words in square brackets should be deleted since they might be misread as unduly restricting the discretion of arbitrators when making the decision to grant an interim measure. After discussion, the Working Group decided that the words between square brackets should be deleted.

*Modification of an interim measure on the initiative of the arbitral tribunal*

37. Diverging views were expressed as to whether an interim measure could be modified or terminated by the arbitral tribunal only upon request by a party or whether such modification or termination could be ordered by the tribunal acting of its own initiative. One view was that the text of draft article 17 should make it abundantly clear that the tribunal could only act upon request by a party. It was stated that a party who had sought and obtained an interim measure had a legitimate expectation that the measure would produce its intended effect over its intended duration. In that context an interim measure granted at the request of a party could only be terminated at the request of that party. More generally, it was stated that such a rule was necessary to ensure consistency with the consensual nature of arbitration as understood in many countries. It was pointed out that, should an arbitral tribunal acting on its own initiative decide to terminate an interim measure granted at the request of a party, it might be seen as unduly protecting the interests of the other party, thus deviating from the impartiality that should be strictly observed by the arbitral tribunal.

38. A contrary view, however, was that a degree of discretion was necessary to make it possible for the arbitral tribunal to correct the serious consequences of an interim measure, particularly where that measure appeared to have been granted on an erroneous or fraudulent basis. It was pointed out that a useful precedent might be found in article 33(2) of the Model Law, which stated, in respect of awards on the merits, that “The arbitral tribunal may correct any error of the type referred to in paragraph (1)(a) of this article on its own initiative within thirty days of the date of the award”.

39. With a view to reconciling the various opinions on that matter, it was suggested that the order of paragraphs (5) and (6) could be reversed. It was stated that placing paragraph (6) before paragraph (5) would appropriately emphasize the obligation of parties to inform the arbitral tribunal of any change in the circumstances on the basis of which the interim measure had been granted. That suggestion was generally accepted by the Working Group. In addition, various suggestions were made for improving the current text of paragraph (5). One suggestion was that the arbitral tribunal should only be allowed to modify or terminate an interim measure on its own initiative where such power had been expressly conferred upon the arbitral tribunal through prior agreement of the parties. The Working Group took note of that suggestion. Another suggestion was that the following text should replace the current text of paragraph (5):

“The arbitral tribunal may modify or terminate an interim measure of protection at any time upon application of any party or upon the tribunal’s own motion upon prior notice to the parties.”

40. Broad support was expressed for the proposed text. However, it was suggested that, in order not to leave too much discretion to the arbitral tribunal acting of its own initiative, paragraph (5) should clearly establish that, while under normal circumstances an interim measure could only be terminated or modified at the request of a party, specific circumstances might justify modification or termination of an interim measure by the arbitral tribunal on its own initiative. To that effect, it was suggested that the words “or upon the tribunal’s own motion upon prior notice to the parties” in the proposed text should be replaced by the words “or, in exceptional circumstances, on the tribunal’s own initiative, upon prior notice to the parties”. A

view was expressed that a reference to “exceptional circumstances” might be overly restrictive. A suggestion was made that broader wording along the lines of “in light of additional information or a change of circumstances” (see above, para. 36) might be preferable. After discussion, however, the Working Group decided that paragraph (5) should be renumbered paragraph (6) and read along the following lines:

“The arbitral tribunal may modify or terminate an interim measure of protection at any time upon application of any party or, in exceptional circumstances, on the tribunal’s own initiative, upon prior notice to the parties.”

41. A concern was expressed that the revised text of the paragraph might be misread as establishing the right for the arbitral tribunal to terminate or modify interim measures granted by another tribunal or by a State court. It was generally agreed that the provision should be further amended to clarify that, irrespective of whether it acted at the request of a party or on its own initiative, the arbitral tribunal could only modify or terminate the interim measures issued by that arbitral tribunal. The Secretariat was requested to implement the common understanding of the Working Group when preparing a revised draft for further consideration at its next session.

*Situation where a respondent objects to the jurisdiction of the arbitral tribunal*

42. A question was raised with respect to the operation of paragraph (5) regarding the power of the arbitral tribunal to modify an interim order already made by the tribunal in the situation where a respondent would not submit to the jurisdiction of the arbitral tribunal. It was stated that this question raised a broader issue with respect to the position of a respondent who objected to the jurisdiction of the arbitral tribunal on the merits of the case but wished to oppose or sought to modify an interim order. It was widely felt that, in such a situation, the respondent should not be regarded as having waived its objection to the jurisdiction of the arbitral tribunal by appearing before the tribunal in connection with the interim order only. With a view to reflecting that policy in draft article 17, the following text was proposed:

“(6) bis

(a) When a party against whom such an application, or an interim order, is made, objects or does not submit to the jurisdiction of the Tribunal in respect of [the merits of] the claim made against him [in the arbitration proceedings], that party may

(i) oppose the application, or

(ii) request the Tribunal to exercise its power [to modify etc.] under subparagraph (5),

without thereby waiving the objection or submitting to the jurisdiction of the Tribunal in respect of [the merits of] the claim.

(b) In such a case, the Tribunal may exercise its power [to modify etc.] under subparagraph (5) notwithstanding that no request [therefore] has been made by the party against whom the interim order was made.”

43. The Working Group took note of the proposal. It was widely felt, however, that, as redrafted to provide for modification or termination of the interim measure on the initiative of the arbitral tribunal in exceptional circumstances (see above, paras. 40 and 41), the paragraph sufficiently addressed the above concern.

## Paragraph (6)

### *Numbering of paragraphs*

44. For the reasons expressed in the context of the discussion of paragraph (5), (para. 39, above), the Working Group decided that paragraph (6) would be renumbered paragraph (5), and paragraph (5) renumbered paragraph (6).

### *Communication of information to both parties*

45. A concern was expressed that paragraph (6) did not require the requesting party to notify the other party of a material change in the circumstances. The Working Group noted that paragraph (3) of article 24 of the Model Law provided that “all statements, documents or other information supplied to the arbitral tribunal by one party shall be communicated to the other party”. As well, article 18 of the Model Law provided that the parties “shall be treated with equality and each party shall be given a full opportunity of presenting his case”. A concern was expressed that duplication of these principles in draft paragraph (6) could be detrimental and that the issue should instead be addressed in a commentary to the Model Law. After discussion, the Working Group agreed that, notwithstanding the obligations set out in article 24(3) and article 18 of the Model Law, it would be useful to require expressly in paragraph (6) that all information supplied to the arbitral tribunal by one party pursuant to that paragraph should also be communicated to the other party.

### *“From the time of the request onward”*

46. It was suggested that the words “from the time of the request onward” could be deleted given that the point at which the duty to inform arose was evident from the remainder of the paragraph, namely from the words “on the basis of which the party sought the interim measure of protection”. It was further suggested that, to clarify the duty to inform, the word “sought” should be replaced by “made the request for”. The Working Group agreed to delete the words “from the time of the request onward” and replace the term “sought” with “made the request for”.

### *“change in the circumstances”*

47. The view was expressed that, as a matter of consistency, the language used in respect of an arbitral tribunal’s power to modify or terminate an interim measure “in light of additional information or a change of circumstances” should be harmonized with that used in paragraph (6) regarding the requesting party’s duty to inform “of any material change in circumstances”. However, it was recalled in that respect that the words “in light of additional information or a change of circumstances” had been deleted from paragraph (5) by the Working Group (see above, para. 36).

### *“Liability of the requesting party”*

48. Concern was expressed that, in contrast to subparagraph (7)(b), which imposed a mandatory requirement that security be given by the party applying for the *ex parte* order to cover possible damages resulting from the measure, no liability provision was included in the context of *inter partes* interim measures of protection which were subsequently shown to have been unjustified. The Working Group

agreed to defer discussion on liability for unjustified interim measures issued in the context of *inter partes* proceedings to a later stage in its deliberations.

### Paragraph (7)

#### General remarks

49. The Working Group recalled that, at the thirty-seventh session, the question whether to include a provision allowing for interim measures to be ordered *ex parte* by an arbitral tribunal had been extensively discussed and that opposing views had been expressed as to whether this matter should be included in draft article 17 (A/CN.9/523, paras. 16-27). The Working Group also recalled that, at its thirty-sixth session, the Commission noted the suggestion that the issue of *ex parte* interim measures, which the Commission agreed remained a point of controversy, should not delay progress on the finalization of draft article 17 (A/58/17, para. 203).

50. Strong opposition was expressed to discussing the text of paragraph (7) before having first a discussion on whether, as a matter of general policy, it would be suitable for a revision of the Model Law to establish the possibility of interim measures to be ordered *ex parte* by an arbitral tribunal. However, the Working Group was reminded that, at its thirty-seventh session, there had been wide agreement that, by strengthening and increasing the safeguards, a provision on *ex parte* interim measures of protection might be more acceptable (A/CN.9/523, para. 27). On that basis, the Working Group agreed to proceed with an examination of the text and following that to consider whether, as a matter of general policy, a provision on interim measures granted *ex parte* should be retained in draft article 17.

51. A proposal was made to add to subparagraph 7(a) new wording to cover the question of jurisdictional immunities of States and their property, along the following lines : “This subparagraph is without prejudice to the immunities enjoyed by States or their various organs under international law in relation to measures of protection.”

#### Subparagraph (a)

##### *Opt in or opt out*

52. As currently drafted, the power to order interim measures applied “Unless otherwise agreed by the parties”. It was proposed that these words should be deleted from the text and replaced by “If expressly agreed by the parties”. It was stated that the suggested wording was more apt to preserve the consensual nature of arbitration. It was suggested that this approach which provided that parties “opt in” to a provision allowing *ex parte* interim measures was more consistent with the expectation of the parties in an arbitration given that *ex parte* provisions were not specifically provided for in a large number of domestic arbitration laws. The Working Group took note of that suggestion, for which some support was expressed. It was stated that experience gathered by one major international arbitral centre over many years indicated that parties never requested *ex parte* interim measures.

##### *“in exceptional circumstances”*

53. Divergent views were expressed as to whether or not to retain the bracketed words “in exceptional circumstances”. It was suggested that the words were



redundant and should be deleted given that the circumstances listed in subparagraphs (a)(i) to (iii) only referred to exceptional circumstances. As an alternative to deletion, it was suggested that the words “in exceptional circumstances” could be retained, provided that appropriate clarification was introduced in the text that “exceptional circumstances” referred to those circumstances listed in subparagraphs (a)(i) to (iii). Such clarification was said to be necessary in order not to suggest that the reference to “exceptional circumstances” should be interpreted as establishing a further condition to the issuance of an interim measure *ex parte* in addition to those already listed in subparagraphs (a)(i) to (iii). A contrary view was that the words should be retained to underscore that the *ex parte* measure should only be granted in truly exceptional circumstances. In support of that view, it was said that the circumstances listed in subparagraph (a) were not necessarily exceptional circumstances. The Working Group did not reach consensus on that issue and decided that the words “in exceptional circumstances” should be retained in square brackets for continuation of the discussion at a future session.

“*[against whom the measure is directed][affected by the measure]*”

54. The Working Group agreed that the words “against whom the measure is directed” were preferable to the words “affected by the measure”. It was said that the latter phrase was ambiguous in view of the multiplicity of parties potentially “affected” by an interim measure. In the light of that decision, it was suggested that the language used in paragraph (3)(a) and in other parts of draft article 17 might need to be reviewed to ensure consistency in terminology, where appropriate.

Subparagraph (a)(i)

55. The Working Group found the substance of subparagraph (a)(i) to be generally acceptable.

Subparagraph (a)(ii)

56. The Working Group agreed to replace the word “circumstances” with the word “conditions” to better reflect the nature of the list contained in paragraph (3). A view was expressed that subparagraph (a)(ii) which only referred to “the circumstances set out in paragraph (3)” could be misinterpreted as excluding the application of paragraphs (5) and (6) to *ex parte* interim measures. It was recalled that subparagraph (a)(ii) had been included for the avoidance of any doubt that all the prerequisites applying to the granting of an *inter partes* interim measure should also apply to an interim measure that was ordered *ex parte*. It was said that, if re-emphasising that point cast doubt on whether or not the other paragraphs applied, then paragraph (a)(ii) should be deleted. The Working Group made no final decision regarding that issue and noted that it might need to be further discussed at a later stage.

Subparagraph (a)(iii)

57. It was suggested that the words, “the requesting party shows” should be harmonized with the amended text agreed to in the chapeau of paragraph (3) which provided that “the requesting party satisfies the arbitral tribunal” (see para. 28, above). Some opposition was expressed to that proposal on the basis that a higher standard of proof should be required in respect of *ex parte* interim measures. The Working Group made no final decision regarding that issue and noted that it might need to be further discussed at a later stage.

58. A suggestion was made that the phrase “the requesting party shows” or any phrase as might be agreed should be transposed to the chapeau of paragraph 7(a) to make it clear that it applied to all the elements of paragraph 7(a) and not only to subparagraph (a)(iii). The Working Group took note of that suggestion.

#### Subparagraph (b)

##### *General remarks*

59. The Working Group recalled that, at its thirty-seventh session, it had agreed that the revised draft should ensure that the requirement that the party seeking the measure give security be mandatory and that the requesting party be considered strictly liable for damages caused to the responding party by an unjustified measure (A/CN.9/523, para. 31).

60. The question was raised whether a general liability provision should apply not only to interim measures ordered on an *ex parte* basis but also to those ordered on an *inter partes* basis. In support of establishing such a general liability provision, it was stated that in either case, the measure could ultimately be found to have been unjustified to the detriment of the responding party. However, some opposition was expressed to the suggestion that subparagraph (b)(i) should apply generally to both *ex parte* and *inter partes* measures. It was said that the strict liability imposed under subparagraph (b)(i) was appropriate given the nature of an *ex parte* measure, due to the risks inherent in such procedure. However, it was said that misrepresentation or fault in relation to the *inter partes* regime could be dealt with by procedural national laws. As a general remark, it was said that the scope of subparagraph (b)(i) should be limited to establishing the basic principles of a liability regime, without dealing in any detail with substantive issues covered by national laws. After discussion, the Working Group agreed that, at its next session, its deliberations should continue on the basis of both subparagraph (7)(b)(i) regarding the liability of the party requesting an *ex parte* measure, and a new paragraph (provisionally numbered (6 bis)), which should mirror the text of subparagraph (7)(b)(i) in the context of *inter partes* measures.

61. In preparation for the continuation of its deliberations on this topic, it was felt that additional research on the liability regimes in the context of national laws on interim measures of protection was needed. Some reservations were expressed as to the usefulness of further research given the scarcity of arbitration laws that included a regime on liability in the context of interim measures of protection, and the possibility that civil procedural laws applicable to State courts might not provide rules that could appropriately be transposed in the context of arbitration proceedings. Nonetheless, after discussion the Working Group agreed that the matter could profit from additional information regarding national law on that matter. Delegations were invited to make such information available to the Secretariat by mid-December 2003 for circulation and translation in preparation for the next session of the Working Group.

62. As a matter of drafting, it was suggested that subparagraphs (b)(i) and (ii) should not be grouped together in one paragraph since those subparagraphs dealt with different issues, respectively liability and security. The Working Group took note of that suggestion.

## Subparagraph (b)(i)

*Costs*

63. Diverging views were expressed as to the need for a reference to costs. It was suggested that the scope of the subparagraph should be restricted to damages, since it was aimed at providing compensation to the responding party for damages arising from an *ex parte* interim measure, under certain conditions. The Working Group was alerted to the danger of including costs, which could be understood very broadly in some jurisdictions and narrowly elsewhere, and which could be interpreted in a variety of ways covering, for example, legal costs, including attorney's fees, or costs associated with implementing the measure. It was suggested that the word "costs" should be interpreted strictly and replaced by the word "expenses". However, there was a suggestion to retain the reference to costs, as the term was defined under the UNCITRAL Arbitration Rules.

*Damages*

64. Concerns were raised that, as currently drafted, the reference to damages was not sufficiently defined as it could cover both direct and indirect or consequential damages caused by the measure. It was suggested that it might be preferable to define more clearly the scope of the damages intended to be covered. Diverging views were expressed as to whether a wider definition of damages (which would provide appropriate safeguards) or a more limited one (restricting the ambit of the rule to direct damages) should be retained.

65. The Working Group considered the circumstances when damages might be payable in respect of an *ex parte* measure. A question was raised as to whether merely requesting an *ex parte* interim measure should make the requesting party liable for damages caused, irrespective of whether the measure was found to be justified or unjustified and irrespective of whether there was any fault by the requesting party. In response, it was widely felt that, irrespective of whether or not the liability rule established in respect of the requesting party was based on fault or not, the application for an *ex parte* interim measure should not be regarded in itself as creating a damage that should be compensated. The view was expressed that the issue of damages should be left to domestic law. The prevailing view, however, was that the requesting party should be liable only if the measure was ultimately found to have been unjustified. Questions were raised as to the meaning to be attributed to the word "unjustified" and whether the notion of an "unjustified" measure should be considered *per se*, or in the light of the results on the merits. It was strongly felt in that respect that the final decision on the merits should not be an essential element in determining whether the interim measure was justified or not.

66. It was suggested that the point in time when compensation for damages could be obtained should be defined. It was pointed out that damages could arise prior to the rendering of the final award. In that connection, it was said that, as an additional safeguard to the regime of *ex parte* measures, the language of the revised draft should include the possibility for the responding party to claim for compensation immediately after the *ex parte* interim measure had been granted by the arbitral tribunal and to obtain immediate awarding of damages. It was also pointed out that

damages for *ex parte* measures would apply only for the time in which the measure was in effect on an *ex parte* basis.

“[*against whom it is directed*] [*affected by the measure*]”

67. Support was expressed for the retention of the first bracketed text for the sake of consistency with the words used in paragraph 3 and subparagraph 7(a). However, it was suggested that, in the context of subparagraph 7(b)(i), it could be preferable to retain the second bracketed text “affected by the measure” as it would allow a party, other than the party against whom the measure was directed, to claim damages. It was also suggested that the words “the party affected by the measure” could, in this context, be replaced by the words “any party affected by the measure”. It was explained that wording establishing the principle of a guarantee on the part of the requesting party would provide appropriate protection to arbitrators against third party’s incurring damages as a result of the *ex parte* interim measure and seeking compensation. In reply to the above suggestions, it was recalled that an arbitral tribunal would not have jurisdiction over third parties not bound by the arbitration agreement.

“[*to the extent appropriate, taking into account all of the circumstances of the case, in light of the final disposition of the claims on the merit*]”

68. Diverging views were expressed as to the need to retain the last bracketed text of subparagraph (b)(i). It was said that the phrase “to the extent appropriate” should be maintained, to show that the measure is legitimate. Other views were expressed stating that the bracketed text was not necessary, as it did not provide any new element. For that reason, it should be replaced by a provision on the possibility for the responding party to claim for compensation immediately after the *ex parte* interim measure was granted by the arbitral tribunal. The Working Group took note of those views.

#### Subparagraph (b)(ii)

69. The Working Group agreed that the provision of security should be mandatory in the context of *ex parte* interim measures. It was pointed out that, as a matter of consistency, the wording of this subparagraph should be aligned with the wording used in paragraph (4) relating to the provision of security in the context of *inter partes* interim measures, except for the word “may” which could be replaced by the word “shall”.

70. It was suggested that, in order to enhance the safeguards necessary in the context of *ex parte* interim measures, subparagraph b(ii) should be made a condition for granting an *ex parte* interim measure.

#### Subparagraph (c)

71. It was suggested that the subparagraph was unnecessary given that the jurisdiction of the arbitral tribunal was implicitly established by subparagraph (7)(b)(i). The prevailing view, however, was that subparagraph (c) served a useful purpose and should be retained. It was agreed that, if both subparagraph (b)(i) and a general provision on liability were included in draft article 17, it should be made clear that subparagraph (c) applied to both *inter partes* and *ex parte* interim measures.

72. A concern was expressed that an application under subparagraph (b)(i) could be made by the responding party well after the final award had been rendered. A suggestion was made that the subparagraph should make it clear that the jurisdiction only applied until the award was decided. In response to the above concern, it was recalled that article 32(3) of the Model Law provided that “the mandate of the arbitral tribunal terminates with the termination of the arbitral proceedings subject to the provisions of article 33 and 34(4)”. However, since the claim under subparagraph (b)(i) could be regarded as a new claim, it was suggested that subparagraph (c) was necessary. A suggestion was made that, since there was no doubt that the arbitral tribunal had jurisdiction on the issue of security under subparagraph (b)(ii), the scope of subparagraph (c) should be restricted to subparagraph (b)(i). The following text was suggested as a possible alternative to the current formulation of subparagraph (c): “A party may bring a claim under subparagraph (b)(i) and may do so at any time during the arbitration proceedings”. The Working Group took note of the suggested wording and decided that it should be further discussed at its next session, together with the current text of subparagraph (c).

73. It was suggested that the words “for the avoidance of doubt,” should be deleted. Concern was expressed that, if those words were omitted, this could lead to uncertainty regarding the existence of arbitral authority under subparagraph (b), particularly in jurisdictions that would not enact subparagraph (c). It was said that the broad drafting of paragraph (c), including the reference to “inter alia”, reduced the risk of any misinterpretation of the provision, the meaning of which could be further clarified in a commentary to article 17. On that basis, the Working Group decided that the opening words “for the avoidance of doubt” should be deleted. The Secretariat was requested to provide a revised draft taking account of the views expressed and the suggestions made.

#### Subparagraph (d)

74. It was pointed out that subparagraph (d) was central to the overall regime applying to *ex parte* interim measures. It was suggested that, to the extent an *ex parte* measure could impact upon parties other than the party against whom it was directed, the second bracketed text would better accommodate this situation along with substituting the opening words “The party” with the words “Any party”. The Working Group, however, agreed that in the interests of consistency with the drafting agreed to in respect of subparagraph (b)(i), the first bracketed text (“against whom it is directed”) should be retained in a future draft of this provision.

75. In respect of the second set of bracketed texts “[as soon as it is no longer necessary to proceed on an *ex parte* basis in order to ensure that the measure is effective] [within forty-eight hours of the notice, or on such other date and time as is appropriate in the circumstances]”, various views were expressed. One view distinguished the first of these texts as referring to the giving of notice to the responding party whereas the second text was said to refer to the responding party’s opportunity to be heard. It was suggested that, given that the two texts had different functions, both should be retained but that the ordering of the language should be amended to read:

“The party against whom the interim measure is directed under this paragraph shall be given notice of the measure as soon as it is no longer necessary to proceed on an *ex parte* basis in order to ensure that the measure is

effective and an opportunity to be heard by the arbitral tribunal within forty-eight hours of the notice, or on such other date and time as is appropriate in the circumstances.”

76. In response, it was said that the term “as soon as it is no longer necessary” was ambiguous and that it was not clear whether the corresponding judgement was to be made by the requesting party or the arbitral tribunal. It was recalled that the only reason to include such a wording was to address the situation where the requesting party sought enforcement of the *ex parte* interim measure. It was suggested that the subparagraph should be redrafted along the following lines:

“The party against whom the interim measure of protection is directed shall be given immediate notice of the measure and an opportunity to be heard by the arbitral tribunal at the earliest possible opportunity and in any event no later than forty-eight hours after that notice, or on such other date and time as is appropriate in the circumstances.”

77. Whilst support was expressed for that proposal as it provided flexibility and some discretion for the tribunal in respect of when the responding party should be heard, concern was expressed that the proposal did not make sufficiently clear the point of time at which notice should be given.

78. Clarifying that issue was considered crucial given that notification was an essential first step to converting an *ex parte* interim measure into an *inter partes* interim measure. It was proposed that paragraph (d) should be amended to provide that the party against whom the interim measure was directed should be given notice of the measure immediately after the arbitral tribunal ordered the measure. Following that notice, the responding party should be given an opportunity to put forward its arguments in writing and, at the request of the responding party, be heard by the arbitral tribunal. It was suggested that that approach avoided any need to refer to either time period mentioned in the last two bracketed texts of paragraph (d). That proposal was objected to on the grounds that giving notice immediately after the interim measure was ordered might not satisfy the requirement of surprise needed to give efficacy to *ex parte* measures, including time to seek enforcement in court.

79. Some reservations were expressed as to the inclusion of a time period of forty-eight hours or any other specific time period, which might prove too rigid and inadequate, depending on the circumstances. It was also pointed out that introducing wording to allow the tribunal to consider another time and date as was appropriate in the circumstances might provide appropriate flexibility but might also make it illogical to maintain in the same provision a reference to a fixed period of time. A widely shared view, however, was that the inclusion of a specific time period served two purposes, being to underscore that the opportunity to be heard was urgent and, also to put the arbitral tribunal on notice that it should be ready to reconvene to allow an opportunity for the responding party to be heard.

80. It was suggested that the words “opportunity to be heard” might need to be amended to encompass both a hearing of the responding party and a written submission from that party. It was agreed that these words should be replaced by “opportunity to present its case”.

81. After discussion, the Working Group decided that its deliberations in respect of subparagraph (d) should be continued at its next session on the basis of the text reproduced in paragraph 76 above (subject to the replacement of the words “an opportunity to be heard by” by the words “opportunity to present its case before”) and of the following alternative text:

“Any party affected by the interim measure of protection granted under this paragraph shall be given immediate notice of the measure and an opportunity to be heard by the arbitral tribunal within [forty-eight] hours of the notice, or on such other date and time as is appropriate in the circumstances.”

82. At the close of the discussion, the Working Group was reminded that the drafting of subparagraph (d) would need to be revisited when the Working Group examined the question whether enforcement of an *ex parte* interim measure should be permitted.

#### Subparagraph (e)

83. The Working Group considered various drafting improvements on the current text of subparagraph (e). It was agreed that the text could be simplified and include wording along the lines of “expire after twenty days” instead of “be effective for no more than twenty days”. It was also agreed that the reference to “paragraph (1)” was inappropriate. In respect of the second set of alternative bracketed texts, preference was expressed for the first formulation, namely, “from the date on which the arbitral tribunal orders the measure”. In support of that wording, it was pointed out that it would be difficult to identify the date on which a measure took effect against the other party, as proposed by the second alternative text. In keeping with its earlier decision in respect of equivalent language in subparagraph (b)(i), the Working Group agreed to retain the text “against whom the measure is directed” in preference to “affected by the measure”.

84. It was suggested that the second sentence of the subparagraph was unnecessary. It was pointed out, however, that the final sentence in subparagraph (e) effectively allowed for the conversion of an *ex parte* interim measure into an *inter partes* interim measure after the party against whom the measure was directed had been given notice and an opportunity to present its case. Clarification was sought as to the point at which an interim measure was converted from an *ex parte* to an *inter partes* one. It was suggested that, for the sake of clarity, subparagraph (e) could be simplified by adopting a wording along the following lines:

“Any interim measure of protection ordered under this paragraph shall expire after twenty days from the date on which the arbitral tribunal orders the measure, unless that measure has been confirmed, extended or modified by the arbitral tribunal after the party against whom the measure is directed has been given notice and an opportunity to present its case.”

After discussion, that formulation was adopted to replace subparagraph (e).

85. It was observed that the subparagraph had been drafted with procedural orders in mind as shown by the words “confirm, extend or modified”, when, in fact, it was contemplated that it could also apply to interim measures in the form of awards.

86. A suggestion was made that subparagraph (e) could also include a requirement that the requesting party should provide the material on which the application was based to the responding party. In support of that suggestion, it was said that, in light of the obligation to inform contained in subparagraph (f), inclusion of a requirement to provide the material upon which the application was made and the measure granted would improve the operation of subparagraph (f). Whilst the suggestion was considered to be useful, it was noted that article 24(3) already required that information supplied to the arbitral tribunal be communicated to the other party. It was suggested that the Working Group should avoid overburdening the text in the revised draft by restating procedural elements that were already provided for in the Model Law and that the matter could be addressed in any accompanying guide to the Model Law. In response it was said that it was important to restate the requirement that information supplied to the arbitral tribunal be communicated to the other party in paragraph (e) because in an *ex parte* situation, the measure could have been made without any document being provided to the tribunal. It was suggested that, even though article 24(3) of the Model Law could be interpreted as covering oral communications, the requirement should nevertheless be included given that that article could be interpreted restrictively. In response, it was stated that there should be no implication that a tribunal would be under an obligation to make a transcript of oral proceedings for every *ex parte* request.

87. It was said that the paragraph could also better clarify who bore the burden of requesting the maintenance of the order, an issue for which it was important to decide whether the same measure initially issued *ex parte* was maintained in an *inter partes* context or whether a new measure *inter partes* replaced the original *ex parte* measure. It was suggested that the party benefiting from the measure should bear that burden. A note of caution was struck about opening up a variety of procedural matters that would unnecessarily burden the provision. The Secretariat was requested to envisage the possibility of expressing the notion that the party benefiting from the measure should bear the burden of seeking its maintenance beyond twenty days.

#### Subparagraph (f)

##### *General remarks*

88. It was said that the current draft, which referred to an obligation to inform the arbitral tribunal of all the circumstances that it was “likely to find relevant and material to its determination” was ambiguous and difficult to apply in practice, as it would require the requesting party to anticipate the subjective reasoning of the arbitral tribunal. Support was expressed for deletion of subparagraph (f). The prevailing view, however, was that the subparagraph should be retained as a fundamental safeguard and an essential condition to the acceptability of *ex parte* interim measures. In that context, it was recalled that the subparagraph was inspired from the rule in existence in certain jurisdictions that counsel had a special obligation to inform the court of all matters, including those that spoke against its position. It was also recalled, however, that under many legal systems, there existed no such specific obligation to inform.

##### *Placement of subparagraph (f)*



89. Diverging views were expressed as to where this provision should be placed. One view expressed was that, as the subparagraph imposed an obligation on the requesting party, it would be better if it were relocated as the first subparagraph under subparagraph (b). The obligation of the requesting party would therefore consist in informing the arbitral tribunal, providing security and being liable for any costs and damages caused to the responding party. The prevailing view was that the subparagraph should remain in its present location, as it concluded the paragraph on *ex parte* measures with an obligation that referred to various subparagraphs therein.

#### *Sanctions*

90. The Working Group recalled that, at its thirty-seventh session, it was suggested that a further redraft of the provision should establish a clear link between the obligation to disclose a change in circumstances and the liability regime applicable to the party requesting the interim measure (A/CN.9/523, paras. 49 and 76). The Working Group agreed that the consequence for not complying with the obligation of information should be left to be decided by the general regime provided for in paragraph 7 (including termination or liability where the interim measure was unjustified) and otherwise provided by the applicable substantive law.

#### *Redrafting proposals*

91. Sympathy was expressed for the concern that, as currently drafted, the subparagraph appeared to require the requesting party to read the mind of the arbitral tribunal. A number of suggestions were made to reduce the ambiguities of the current draft. One proposal was to replace the phrase “shall have an obligation to inform” by “shall promptly inform”. However, it was said that the word “promptly” was more appropriate in the context of a continuous obligation to inform of any change in circumstances. Another proposal was to replace the entire text in the paragraph by wording along the following lines:

“A party requesting an interim measure of protection under this paragraph shall inform the arbitral tribunal of all material circumstances known to the party, adverse to the party’s case, that the requirements of this paragraph have been met.”

It was suggested that that proposal was preferable to the existing text because it did not depend on a subjective opinion of the tribunal and also addressed the party’s knowledge at the time that the request was made. That proposal was objected to on the grounds that it might only be properly applied and understood by the States from an adversarial regime, as opposed to an inquisitorial one. It was added that the word “material” could exclude certain information that might be useful for the arbitral tribunal. As well, it was said that the proposal introduced further uncertainty into the scope of the duty, as it was not clear what would constitute information adverse to the requesting party’s case. Also it was said that the proposal might be construed to include adverse matters that might arise in the discussion of the merits. It was suggested that the Working Group should seek a more flexible formulation to encourage full and frank disclosure of relevant and material information.

92. It was proposed that the paragraph could be redrafted along the following lines:

“A party requesting an interim measure of protection under this paragraph shall promptly inform the arbitral tribunal of all circumstances relevant and material to the arbitral tribunal’s determination whether the requirements of this paragraph have been met.”

Support was expressed for that proposal. With a view to clarifying that the arbitral tribunal retained the discretion whether or not to order an interim measure of protection, it was suggested that the reference to “whether the requirements of this paragraph have been met”, could be replaced by “whether the arbitral tribunal should make the order requested”. A view was also expressed that the requirement to “inform the arbitral tribunal” might be too narrow and that wording along the lines of “place before the tribunal” might be preferable. Another view was that an effort should be made to introduce in the proposed text some of the flexibility reflected in the original formulation of subparagraph (f). The Secretariat was asked to prepare a revised draft, taking account of the above suggestions.

#### **IV. Revised draft of article 17 bis of the UNCITRAL Model Law on International Commercial Arbitration on the recognition and enforcement of interim measures of protection**

93. The Working Group recalled that it had agreed that, following its completion of paragraph 7, it would revert to a general discussion on whether the inclusion of a provision on *ex parte* interim measures was acceptable or not (see above, para. 50). However, it was agreed that that general debate would take place after the provisions on recognition and enforcement of interim measures had been reviewed.

94. The Working group proceeded to discuss draft article 17 bis, which read as follows:

“(1) An interim measure of protection issued by an arbitral tribunal, that satisfies the requirements of article 17, shall be recognized as binding and, unless otherwise provided by the arbitral tribunal, enforced upon application [in writing] to the competent court, irrespective of the country in which it was issued, subject to the provisions of this article.\*

“(2) The court may only refuse to recognize [and] [or] enforce an interim measure of protection:

“(a) If, at the request of the party against whom it is invoked, the court is satisfied that:

“(i) *Variant 1:* There is a substantial issue as to the jurisdiction of the tribunal [[of such a nature as to make recognition or enforcement inappropriate] [of such a nature as to make the interim measure unenforceable]] [and no appropriate security was ordered by the arbitral tribunal in respect of that interim measure];

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\* The conditions set forth in this article are intended to limit the number of circumstances in which the court may refuse to enforce an interim measure of protection. It would not be contrary to the level of harmonization sought to be achieved by these model provisions if a State were to adopt fewer circumstances in which enforcement may be refused.

*Variant 2:* There is a substantial question relating to any grounds for such refusal set forth in article 36, paragraphs (1)(a)(i), (iii) or (iv); or

“(ii) *Variant 1:* That party was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings [, in which case the court may suspend the enforcement proceedings [until the parties have been heard by the arbitral tribunal] [until the parties have had an opportunity to be heard by the arbitral tribunal] [until the parties have been properly notified]];

*Variant 2:* Such refusal is warranted on the grounds set forth in article 36, paragraph (1)(a)(ii); or

“(iii) *Variant 1:* That party was unable to present its case with respect to the interim measure [in which case the court [may] [shall] suspend the enforcement proceedings until the parties have been heard by the arbitral tribunal]; or

*Variant 2:* Such refusal is warranted on the grounds set forth in article 36, paragraph (1)(a)(ii); or

“(iv) The interim measure has been terminated or suspended by the arbitral tribunal or by order of a competent court; or

“(b) If the court finds that:

“(i) The interim measure requested is incompatible with the powers conferred upon the court by its laws, unless the court decides to reformulate the interim measure to the extent necessary to adapt it to its own powers and procedures for the purposes of enforcing that interim measure and without modifying its substance; or

“(ii) *Variant 1:* The recognition or enforcement of the interim measure would be contrary to the public policy recognized by the court.

*Variant 2:* Any of the grounds set forth in article 36, paragraphs (1)(b)(i) or (ii) apply to the recognition and enforcement of the interim measure.

“(3) Any determination made by the court on any ground in paragraph (2) of this article shall be effective only for the purposes of the application to recognize and enforce the interim measure of protection.

“(4) The party who is seeking or has obtained enforcement of an interim measure of protection shall promptly inform the court of any termination, suspension or amendment of that interim measure.

“(5) *Variant A:* The court where recognition or enforcement is sought may, if it considers it proper, order the other party to provide appropriate security for costs [unless the tribunal has already made an order with respect to security for costs] [unless the tribunal has already made an order with respect to security for costs, except when the court finds that the order is inappropriate or insufficient in the circumstances].

*Variant B:* The court where recognition or enforcement is sought may, if it considers it proper, order security for costs.

*Variant C:* The court where recognition or enforcement is sought shall not, in exercising that power, undertake a review of the substance of the interim measure of protection.

*Variant D:* The court where recognition or enforcement is sought may only order security for costs where such an order is necessary to protect the rights of third parties.

“(6) Paragraph (2)(a)(ii) does not apply.

*Variant X:* To an interim measure of protection that was ordered without notice to the party against whom the interim measure is invoked provided that the interim measure was ordered to be effective for a period not exceeding [thirty] days and the enforcement of the interim measure is requested before the expiry of that period.

*Variant Y:* To an interim measure of protection that was ordered without notice to the party against whom the interim measure is invoked provided that such interim measure is confirmed by the arbitral tribunal after the other party has been able to present its case with respect to the interim measure.

*Variant Z:* If the arbitral tribunal, in its discretion, determines that, in light of the circumstances referred to in article 17(2), the interim measure of protection can be effective only if the enforcement order is issued by the court without notice to the party against whom the interim measure is invoked.”

### **Paragraph (1)**

95. In response to a question regarding the meaning of the words “Unless otherwise provided by the arbitral tribunal”, the Working Group was reminded that these words had been included to reflect the decision that an arbitral tribunal should be able to provide, at the time of ordering the interim measure, that the measure was not to be the subject of an application for court enforcement (A/CN.9/524, paras. 26 and 34).

*“in writing”*

96. A proposal was made to delete the bracketed text “in writing”. That proposal was agreed to.

#### *Footnote to paragraph 1*

97. The Working Group found the substance of the footnote to paragraph 1 to be generally acceptable.

*“that satisfies the requirements of article 17”*

98. The Working Group recalled that paragraph (1) of the revised draft article 17 bis included a broader formulation than that used in an earlier draft by replacing the words “interim measure of protection referred to in article 17” with “an order or award for interim measures issued by an arbitral tribunal, that satisfies the requirements of article 17”. It was recalled that the intention behind that

formulation in the current draft was to ensure that an interim measure that was sought to be enforced would have to comply with the safeguards that had been established in draft article 17, irrespective of whether that measure was ordered in a country that had adopted the Model Law or in another country (A/CN.9/524, para. 32). In support of including a reference to the requirements of article 17 in paragraph (1), it was said it would provide an incentive for the arbitral tribunal to comply more strictly with the conditions defined in article 17.

99. However, it was suggested that the reference to the requirements of article 17 was not necessary because it introduced ambiguity and a concern was expressed that the current text could be interpreted by an enforcing court as requiring it to undertake a review *de novo* of whether the interim measure satisfied the requirements of article 17. To avoid such an interpretation it was proposed to adopt wording along the lines of: “an interim measure of protection issued by an arbitral tribunal, pursuant to article 17 or standards substantially similar to those of article 17, shall be recognized as binding and, unless otherwise provided by the arbitral tribunal enforced upon application to the competent court irrespective of the country in which it was issued subject to the provisions of this article”.

100. While the above-mentioned concern was shared by a number of delegations, it was said that the proposed wording could give rise to two different problems. First, the reference to “standards substantially similar to article 17” might be interpreted as adding an unintended gloss to definition of interim measures of protection. Secondly, creating a link between article 17 and article 17 bis was said to be inappropriate when compared to the approach taken in the New York Convention with respect to the enforcement and recognition of awards. Under the New York Convention the term “award” was not defined with the consequence that the regime of recognition and enforcement applied irrespective of the origin of the award. By contrast, a reference to article 17 in article 17 bis (1) could limit recognition and enforcement of interim measures of protection to countries that had adopted article 17 of the Model Law. It was said that that outcome would run contrary to the pro-enforcement bias favoured by the Working Group in respect of interim measures and also run counter to harmonization of this subject. On that basis, it was suggested that article 17 bis should apply to all interim measures of protection irrespective of whether the measure complied with the requirements of article 17 or not. As well, in any case, it was said that the reference to article 17 was not appropriate as it not only referred to the definition of an interim measure but also included the conditions upon which an arbitral tribunal could grant an interim measure.

101. It was noted that inclusion of the text “that satisfies the requirements of article 17” could have the consequence of creating an additional and hidden ground for the refusal to recognize and enforce an interim measure. It was said that, if it was the intention of the Working Group to include such a ground, then the phrase might be better located under paragraph 2. Some support was expressed for that suggestion. However it was noted that, if such a suggestion were adopted, it would mean that the party against whom the measure was directed would bear the burden of proving that the interim measure did not comply with article 17.

102. In order to take account of this issue it was proposed to delete the reference to “that satisfies the requirements of article 17” and to add another ground on which the court might refuse to recognize and enforce an interim measure under paragraph (2). After discussion, the Working Group adopted that proposal.

**Paragraph (2)***Chapeau*

103. The Working Group agreed, for the sake of consistency with article 36 of the Model Law, to delete from the chapeau of paragraph (2) the word within square bracket “and” and to retain the word “or”. The Working Group adopted the chapeau of paragraph (2) without any other comments.

## Subparagraph (a)

*Chapeau*

104. It was suggested that the phrase “at the request of the party against whom it is invoked” should be deleted, as the court might be satisfied that a ground for non-enforcement existed from the mere examination of the case. In addition, such deletion would cover the situation where a party against whom a measure was invoked did not appear in the proceedings.

## Subparagraph (a)(i)

105. Of the two variants included in the draft subparagraph, preference was expressed for the retention of Variant 2. However it was suggested that the reference to subparagraph 36(1)(a)(i) of the Model Law should be deleted from that variant as it would invite the court to inquire about the validity of the jurisdiction of the arbitral tribunal at a time when the arbitral procedure was still pending. In response, it was said that paragraph (3) of article 17 bis guarded against that risk by restricting any determination made by the court on any ground in paragraph (2) to recognition and enforcement of the interim measure. It was suggested that a general reference to article 36 rather than to specific paragraphs could be considered as an alternative approach. In that case, consideration might be given to the deletion of subparagraph (a)(iv) as it might already be covered by subparagraph 36(1)(a)(v). Another suggestion was that the final decision to adopt Variant 2 could only be made once the Working Group had considered a consolidated version of the various references to article 36 of the Model Law contained in the current version of paragraph (2).

106. It was said that, as there was agreement to retain Variant 2, the question of the burden of proof should be revisited. In that respect, it was noted that by contrast to subparagraph (2)(a), which did not expressly specify who bore the burden of proof, article 36 (1)(a) provided that the party against whom the interim measure was invoked bore that burden.

*Additional ground for refusing recognition and enforcement*

107. Following the suggestion to delete the reference to article 17 from paragraph (1) and to add another ground on which the court might refuse recognition and enforcement of an interim measure (see above, para. 99), it was proposed to add a new subparagraph at the end of paragraph (2) in the following terms:

“(v) The court is satisfied that the arbitral tribunal was prohibited from issuing an interim measure [by the agreement of the parties or the mandatory law of the country where the arbitration is taking place].”

An alternative proposal was made along the following lines:

“(v) The court is satisfied that the arbitral tribunal was not authorized to issue the interim measure [either by the agreement of the parties or by the law of the place of the arbitration].”

It was said that the latter proposal improved upon the earlier one because it recognized that an arbitrator did not have an inherent power to order interim measures and that that power could only be derived from either the agreement of the parties or the applicable law.

108. It was remarked that the bracketed text in that proposed new subparagraph was already covered by article 36 (1)(a)(iii), a reason for which it should probably be deleted. With respect to the reference to the law applicable at the seat of the arbitral tribunal, it was stated that, for example, it would be difficult for a judge to enforce an interim measure when the law of the country where the arbitration took place did not allow such a procedure despite a contrary agreement of the parties. It was stated that the reference to the agreement of the parties or to the applicable law should not be provided for in the revised proposal because the matter should be left to be decided by the court.

109. It was questioned whether referring to the country where the arbitration was taking place was appropriate and whether a reference to the country where recognition and enforcement was sought did not constitute a better approach. It was noted however that article 36 (1)(a)(iv) referred to the “law of the country where the arbitration took place” and that, for the sake of consistency, that wording might need to be maintained. In response, it was stated that the reference to the law of the country where “the arbitration took place” might not be appropriate given that what was intended to be covered was the *lex arbitri* and that arbitrators might not be physically present in the legal jurisdiction governing the arbitration. On that basis, it was suggested that it might be more appropriate to refer to “the law governing the arbitral proceedings”.

110. With respect to the suggested additional ground for refusing recognition and enforcement, the view was expressed that such a provision was unnecessary since the matter was adequately covered by article 36.

111. While the recognition and enforcement regime as defined under article 17 bis was suitable for *inter partes* measures, it was suggested that its application to *ex parte* measures might need to be reviewed.

112. The Working Group agreed that the discussion on draft article 17 bis would need to be continued at its next session. The Secretariat was requested to prepare a revised draft taking account of the various views and suggestions expressed above.

**B. Note by the Secretariat on the settlement of commercial disputes:  
interim measures of protection, working paper submitted to  
the Working Group on Arbitration at its thirty-ninth session  
(A/CN.9/WG.II/WP.125) [Original: English]**

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## **Introduction**

1. At its thirty-seventh session (Vienna, 7-11 October 2002), the Working Group had a brief discussion on the issue of recognition and enforcement of interim measures of protection, based on a note prepared by the Secretariat (A/CN.9/WG.II/WP.119, para. 83), which contained a draft text (also reproduced in A/CN.9/523, para. 78) (hereinafter referred to as “the draft enforcement provision”). The Working Group also heard a brief exchange of views on the possible treatment of interim measures ordered by a court in the context of the revision of article 17 of the UNCITRAL Model Law on International Commercial Arbitration (A/CN.9/523, para. 77) (hereinafter referred to as the “UNCITRAL Model Law”).



2. At its thirty-eighth session (New York, 12-16 May 2003), the Working Group discussed the provision on recognition and enforcement of interim measures of protection on the basis of the draft enforcement provision and later considered a revised draft (reproduced in A/CN.9/524, para. 30) (hereinafter referred to as the “revised draft”). The Working Group also considered a possible draft provision expressing the power of the court to order interim measures of protection in support of arbitration (A/CN.9/524, paras. 76-78).

3. This note has been prepared on the basis of discussions and decisions of the thirty-eighth session of the Working Group and includes two revised versions, one relating to recognition and enforcement of interim measures of protection (Part I), the other relating to the power of courts to order interim measures of protection (Part II).

## **I. Draft provision on the recognition and enforcement of interim measures of protection (for insertion as a new article of the UNCITRAL Model Law on International Commercial Arbitration, tentatively numbered 17 bis)**

4. To facilitate the resumption of discussions, the following text sets out a newly revised version of the provision on recognition and enforcement of interim measures of protection (hereinafter referred to as “draft article 17 bis”):

### **A. Text of draft article 17 bis**

(1) An interim measure of protection issued by an arbitral tribunal, that satisfies the requirements of article 17, shall be recognized as binding and, unless otherwise provided by the arbitral tribunal, enforced upon application [in writing] to the competent court, irrespective of the country in which it was issued, subject to the provisions of this article.\*

(2) The court may only refuse to recognize [and][or] enforce an interim measure of protection:

(a) If, at the request of the party against whom it is invoked, the court is satisfied that:

(i) *Variant I:* There is a substantial issue as to the jurisdiction of the tribunal [[of such a nature as to make recognition or enforcement inappropriate][of such a nature as to make the interim measure unenforceable]][and no appropriate security was ordered by the arbitral tribunal in respect of that interim measure];

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\* The conditions set forth in this article are intended to limit the number of circumstances in which the court may refuse to enforce an interim measure of protection. It would not be contrary to the level of harmonization sought to be achieved by these model provisions if a State were to adopt fewer circumstances in which enforcement may be refused.

*Variant 2:* There is a substantial question relating to any grounds for such refusal set forth in article 36, paragraphs (1)(a)(i), (iii) or (iv); or

(ii) *Variant 1:* That party was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings[, in which case the court may suspend the enforcement proceedings [until the parties have been heard by the arbitral tribunal][until the parties have had an opportunity to be heard by the arbitral tribunal][until the parties have been properly notified]];

*Variant 2:* Such refusal is warranted on the grounds set forth in article 36, paragraph (1)(a)(ii); or

(iii) *Variant 1:* That party was unable to present its case with respect to the interim measure [in which case the court [may][shall] suspend the enforcement proceedings until the parties have been heard by the arbitral tribunal]; or

*Variant 2:* Such refusal is warranted on the grounds set forth in article 36, paragraph (1)(a)(ii); or

(iv) The interim measure has been terminated or suspended by the arbitral tribunal or by order of a competent court; or

(b) If the court finds that:

(i) The interim measure requested is incompatible with the powers conferred upon the court by its laws, unless the court decides to reformulate the interim measure to the extent necessary to adapt it to its own powers and procedures for the purposes of enforcing that interim measure and without modifying its substance; or

(ii) *Variant 1:* The recognition or enforcement of the interim measure would be contrary to the public policy recognized by the court.

*Variant 2:* Any of the grounds set forth in article 36, paragraphs (1)(b)(i) or (ii) apply to the recognition and enforcement of the interim measure.

(3) Any determination made by the court on any ground in paragraph (2) of this article shall be effective only for the purposes of the application to recognize and enforce the interim measure of protection.

(4) The party who is seeking or has obtained enforcement of an interim measure of protection shall promptly inform the court of any termination, suspension or amendment of that interim measure.

(5) *Variant A:* The court where recognition or enforcement is sought may, if it considers it proper, order the other party to provide appropriate security for costs [unless the tribunal has already made an order with respect to security for costs] [unless the tribunal has already made an order with respect to security for costs, except when the court finds that the order is inappropriate or insufficient in the circumstances].

*Variant B:* The court where recognition or enforcement is sought may, if it considers it proper, order security for costs.

*Variant C:* The court where recognition or enforcement is sought shall not, in exercising that power, undertake a review of the substance of the interim measure of protection.

*Variant D:* The court where recognition or enforcement is sought may only order security for costs where such an order is necessary to protect the rights of third parties.

(6) Paragraph (2)(a)(ii) does not apply

*Variant X:* To an interim measure of protection that was ordered without notice to the party against whom the interim measure is invoked provided that the interim measure was ordered to be effective for a period not exceeding [thirty] days and the enforcement of the interim measure is requested before the expiry of that period.

*Variant Y:* To an interim measure of protection that was ordered without notice to the party against whom the interim measure is invoked provided that such interim measure is confirmed by the arbitral tribunal after the other party has been able to present its case with respect to the interim measure.

*Variant Z:* If the arbitral tribunal, in its discretion, determines that, in light of the circumstances referred to in article 17(2), the interim measure of protection can be effective only if the enforcement order is issued by the court without notice to the party against whom the interim measure is invoked.

## **B. General remark on the new provisions**

5. The Working Group will note that article 17 bis and the proposed article 17 ter (set out below under paragraphs 40 and 42) are intended for inclusion in the UNCITRAL Model Law following the proposed new article 17 (see A/CN.9/WG.II/WP.123). The Working Group may wish to consider whether these provisions should be grouped together in a new chapter of the UNCITRAL Model Law, for example, Chapter IV bis, which could be entitled “Interim measures of protection”. Alternatively, the current title of Chapter IV, which now reads “Jurisdiction of Arbitral Tribunal” could be modified to better reflect the inclusion of these new provisions.

## **C. Notes on draft article 17 bis**

### **Paragraph (1) (previously paragraphs 1 and 2 of the revised draft as reproduced in A/CN.9/524, para. 30)**

6. Paragraphs (1) and (2) of the revised draft have been merged into one paragraph to align it more closely with the wording of article 35 of the UNCITRAL Model Law.

7. Paragraph (1) of draft article 17 bis is intended to reflect the decisions of the Working Group that the provision should:

- First provide a positive statement that an interim measure should be recognized and enforced and then set out the grounds upon which recognition or enforcement could be refused (A/CN.9/524, paras. 28 and 34);
- Include the following formulation: “An interim measure issued by an arbitral tribunal, that satisfies the requirements of Article 17” (see A/CN.9/524, para. 32); and
- Also include the words “irrespective of the country in which it was ordered” (see A/CN.9/524, para. 33).

8. The words “Unless otherwise provided by the arbitral tribunal” have been included to reflect the decision that an arbitral tribunal should be able to provide, at the time of ordering the interim measure, that the measure was not to be the subject of an application for court enforcement (A/CN.9/524, paras. 26 and 34).

9. As a matter of drafting, it was suggested that paragraph (2) of the revised draft could omit the words “recognized and” since recognition was implied in enforcement. However, concern was expressed that both these terms should be included for the sake of consistency with other draft provisions as well as articles 34 and 35 of the UNCITRAL Model Law (A/CN.9/524, para. 34). The revised text appears to make this concern redundant.

10. The words “in writing” have been placed in square brackets. When finalizing the text of article 17 bis(1), the Working Group may wish to keep in mind that the term “in writing” is included in a number of provisions in the UNCITRAL Model Law, being articles 7(2), article 31(1) and 35(1). As there is no general definition of the term in the UNCITRAL Model Law, and given that the Working Group is yet to finalize a decision revising article 7(2) of the UNCITRAL Model Law, the Working Group may wish to either avoid a reference to the term unless it is essential, or consider the inclusion of a global definition that would be electronic commerce friendly, in the interest of uniform interpretation.

**Footnote to paragraph (1)**

11. The Working Group agreed to retain the footnote with the amendment to replace “must”, where it appeared in the footnote, with the word “may” (A/CN.9/524, paras. 64-66).

**Paragraph (2) (previously paragraph (3) of the revised draft)****General remarks**

12. At the close of the discussion regarding the individual grounds for refusing enforcement of an interim measure issued by an arbitral tribunal, it was observed that one of the results achieved by the Working Group had been to bring those various grounds somewhat closer to the grounds listed in articles 35 and 36 of the Model Law and in article V of the New York Convention. It was thus suggested that, instead of formulating each of those individual grounds, the paragraph could be recast in the form of a general reference to “the provisions of articles 35 and 36” (A/CN.9/524, para. 57). The Secretariat was requested to consider the possibility of drafting alternative variants so that the Working Group would have concrete texts before it when discussing the matter further at a future session. Variants 2 under subparagraphs (a) (i), (ii) and (iii) and (b) (ii) provide texts giving effect to these suggestions. The Working Group may wish to note that a reference to article 36, paragraph (1) (a) (ii) is repeated under both subparagraphs (ii) and (iii) of the revised draft as it covers questions of notice and inability to present the case.

13. Another view was that a reference to article 35 and 36 of the Model Law should be avoided to facilitate the use of the draft enforcement provision by those States that might not have already enacted the Model Law. It was said that it was preferable to spell out in the Model Law the provisions applicable to the enforcement of interim measures issued by an arbitral tribunal since the policy and legal considerations governing the enforcement of those measures were sufficiently different from those governing the enforcement of an arbitral award (A/CN.9/524, para. 57). Variants 1 under subparagraphs (a)(i), (ii) and (iii) and (b)(ii) provide texts giving effect to these suggestions.

*Chapeau*

14. To emphasize that the circumstances in which refusal could occur were limited, the word “only” has been included after the word “may” (A/CN.9/524, para. 35). For the sake of consistency with article 36 of the UNCITRAL Model Law, and also to better reflect the options available to the court, the Working Group may wish to decide whether the word “and” could be replaced by “or”.

15. The structure of paragraph (2) reflects the decision of the Working Group (A/CN.9/524, para. 62).

**Subparagraph (a), chapeau (previously paragraph 1(a) of the draft enforcement provision as reproduced in A/CN.9/523, para. 78)**

16. The redraft reflects the decision that no provision should be made regarding the allocation of the burden of proof and that the matter should be left to applicable law (A/CN.9/524, paras. 35-36, 42, 58 and 60). The Working Group may wish to consider that the current text, which omits any reference to the burden of proof, appears to be inconsistent with the approach taken in articles 34 and 36 of the UNCITRAL Model Law. If so, this might lead to different interpretations such as imposing a burden of proof on the party asking for enforcement or implying that it was for the arbitral tribunal to verify these requirements *ex officio*. If the Working Group agrees that this different wording is justified given the different objectives of article 17 bis as compared to articles 34 and 36, the Working Group should seek to

elaborate the reasons for this difference in drafting to avoid uncertainty in interpretation.

**Subparagraph (a)(i) (previously subparagraph (a) of the revised draft and paragraph 1(a)(i) of the draft enforcement provision)**

*Variant 1*

17. Variant 1 spells out the provisions applicable to the enforcement of interim measures issued by an arbitral tribunal based on the approach that the policy and legal considerations governing the enforcement of those measures were sufficiently different from those governing the enforcement of an arbitral award (A/CN.9/524, para. 57).

18. The Working Group agreed that in order for a court to have discretion to refuse to recognize and enforce an interim measure, the court should not only be satisfied that there was a substantial issue but also that that issue was an appropriate basis on which to refuse enforcement and recognition. That broader approach was widely supported (A/CN.9/524, para. 37). To reflect more expressly that approach, the draft text includes alternative bracketed wording providing that the substantial issue should be of such a nature as to either make recognition or enforcement inappropriate or make the interim measure unenforceable (A/CN.9/524, para. 37).

19. It was also noted that any revision of subparagraph (a) of the revised draft should take account of discussions regarding the requirement that security ought to be provided when an interim measure was granted (A/CN.9/524, para. 39). In this context, the Working Group may wish to consider, as has been provided in square brackets in the text, whether subparagraph (a) should be subject to whether or not security was ordered by the arbitral tribunal in respect of the interim measure that is sought to be recognized and enforced.

*Variant 2*

20. For a discussion of this variant, see paragraphs 12 and 13 above.

**Subparagraph (a)(ii) (previously paragraph 1(a)(ii) of the draft enforcement provision)**

*Variant 1*

21. The current text includes several variants to the effect that the court might suspend the enforcement proceedings until the parties have:

- Been heard by the arbitral tribunal;
- Had an opportunity to be heard by the arbitral tribunal;
- Been properly notified (A/CN.9/524, para. 45).

The Working Group may wish to consider whether the first two variants introduce an overly formalistic condition which could result in unnecessary delays to enforcement of an interim measure.

*Variant 2*

22. See comments under paragraphs 12 and 13 above.

**Subparagraph (a)(iii) (previously paragraph (1)(a)(iii) of the draft enforcement provision)***Variant 1*

23. The substance of the subparagraph was found to be generally acceptable (A/CN.9/524, para. 46). The text retains the bracketed language “[in which case the court [may][shall] suspend the enforcement proceedings until the parties have been heard by the arbitral tribunal]”. The usefulness of the bracketed language was questioned. It was stated that the bracketed language described only one among many options which would normally be open to a state court under domestic law where a party had not been given full opportunity to present its case under article 18 of the Model Law. From that perspective, the bracketed language would only prove useful in the unlikely situation where the domestic rules of procedural law would not allow a court to order suspension of the proceedings. The Working Group may wish to decide whether or not the text should be retained, and if so, whether to retain the word “shall” or “may”. It should be recalled that a view had been expressed that, in order to preserve the broadest possible discretion for the court, “may” was the preferable option (A/CN.9/524, para. 46).

*Variant 2*

24. See comments under paragraphs 12 and 13 above.

**Subparagraph (a)(iv) (previously paragraph (1)(a)(iv) of the draft enforcement provision)**

25. The substance of this subparagraph was found to be generally acceptable. The words “or by order of a competent court” have been added to deal with a situation where an interim measure has been set aside by a court in the country of the seat of the arbitration (A/CN.9/524, para. 47).

**Subparagraph (b)(i) (previously paragraph (1)(b)(i) of the draft enforcement provision)**

26. As previously drafted, subparagraph (b)(i) referred to “procedural laws”. As decided by the Working Group, the reference to the term “procedural” has been omitted on the basis that there were substantial differences between the content of different procedural laws in different jurisdictions and that boundaries between substantive laws and procedural laws also varied between different jurisdictions (A/CN.9/524, para. 48). As well, it was said that a court may refuse to recognize or enforce an interim measure for the reason that it was incompatible with the powers conferred upon it by its substantive laws.

27. The redraft reflects the decision of the Working Group to combine paragraph 4 of the draft enforcement provision (which read: “in reformulating the measure under paragraph 1(b)(i), the court shall not modify the substance of the interim measure”) with this subparagraph (A/CN.9/524, para. 49).

**Subparagraph (b)(ii) (previously paragraph (1)(b)(ii) of the draft enforcement provision)***Variant 1*

28. As decided by the Working Group, the phrase “this State” has been omitted from the draft paragraph, even though the phrase is used in paragraph 36(1)(b)(ii) of the UNCITRAL Model Law, on the basis that it was considered unnecessary (A/CN.9/524, paras. 50-51).

29. The provision has been revised to refer to “public policy recognized by the court” (A/CN.9/524, paras. 38 and 52). The Working Group will recall that the term “public policy” was regarded as a very vague term that was insusceptible to definition in a number of countries and could encompass at least three different meanings being: domestic public policy understood as covering all mandatory provisions of domestic legislation; public policy rules specifically established in domestic legislation for international relationships and the very limited set of rules established at the transnational level and sometimes referred to as international public policy.

30. The Working Group may wish to consider the consequences of any discrepancies between this subparagraph and other provisions of the UNCITRAL Model Law, namely paragraph (b)(ii) of article 34 and paragraph (b)(ii) of article 36 and to decide whether it would be appropriate, in the interests of uniform interpretation, to define the term “public policy” for the purposes of the UNCITRAL Model Law.

*Variant 2*

31. See comments under paragraphs 12 and 13 above.

**Paragraph (3) (previously paragraph (4) of the revised draft)**

32. The redraft took account of the concern expressed in the Working Group’s discussions on the risk that a court, in considering a request for enforcement of an interim measure, could hinder the arbitral tribunal’s right to determine its own competence (A/CN.9/524, paras. 22 and 40).

33. The Working Group agreed to add the words “by the court” following the word “made” to clarify that the paragraph was addressed to a court and not to an arbitral tribunal, and also to provide a clearer link between that paragraph and paragraph (2) (previously paragraph (3) of the revised draft) (A/CN.9/524, para. 56).

**Paragraph (4) (previously paragraph (3) of the enforcement provision)**

34. Consistent with the decision taken by the Working Group that the obligation to notify also extended to the period after an enforcement order had been granted, the expression “the party who is seeking enforcement” has been replaced with “the party who is seeking or has obtained enforcement” (A/CN.9/524, para. 69).

**Paragraph (5) (new provision)**

35. As requested by the Working Group, this provision addresses the question of whether a court, when faced with an application to enforce an interim measure,



ought to be able to order the applicant to provide security (A/CN.9/524, paras. 72-75).

36. Variant A provides that a court has the power to order security and includes bracketed text that limits such a power to the circumstance where a tribunal has not made an order with respect to security as well as another option extending this power to include a power to order security where an arbitral tribunal has made an order but the court has found that order to be inappropriate or insufficient in the circumstances. Variant B merely provides that a court has the discretion to order security for costs. Under this variant, the scope of the power, as well as any potential conflict with an earlier determination by an arbitral tribunal on security, would be dealt with by the court under a law other than the UNCITRAL Model Law. Variant C has been drafted to cover the suggestion that the power of a court be limited to the question whether or not to enforce an interim measure. The suggested text expressly provides that the power of the court should not extend to reviewing the substance of the interim measure. If this variant is the preferred option, the draft article will contain no provision expressly granting the court the right to order security when recognizing or enforcing an interim measure. Variant D limits the power of the court to order security to protect third party rights. As the term “third party” is not defined, if variant D is the preferred option, the Working Group may wish to clarify the term.

37. The Working Group might be willing to further consider the issue of security for costs ordered by courts in the light of the Hague Conventions on Civil Procedure of 1905 and 1954, which prohibit security for costs being required from nationals of signatory States. Article 17 of the 1954 Hague Convention on Civil Procedure provides as follows:

“No bond, nor deposit, under any denomination whatsoever, may be imposed on the ground, whether of their foreign character or of absence of domicile or residence in the country, upon nationals of one of the contracting States, having their domicile within one of such States, who are plaintiffs or intervene in the tribunals of another of such States.

The same rule applies to payments which may be required of plaintiffs or interveners to guarantee judicial costs.

Conventions by which contracting States may have stipulated on behalf of their nationals exemption from security for costs and damages in proceedings or from payment of judicial costs irrespective of domicile, shall continue to apply.”

**Paragraph (6) of the redraft (previously paragraph 5 of the enforcement provision)**

38. This paragraph was not discussed at the thirty-eighth session of the Working Group.

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39. Article 35(2) of the Model Law provides that “the party relying on an award or applying for its enforcement shall supply the duly authenticated original award or a duly certified copy thereof and the original arbitration agreement ... or a duly

certified copy thereof". As well the article provides that if "the award or agreement is not made in an official language of this State, the party shall supply a duly certified translation thereof into such language." At its thirty-eighth session, the Working Group generally agreed that, in drafting paragraph (1) "unnecessary deviation from the text of articles 35 and 36 should be avoided" (A/CN.9/524, para. 57). On that basis, the Working Group may wish to consider whether language along the lines of articles 35(2) should be included in the current text.

## **II. Draft provision on the power of courts to order interim measures of protection in support of arbitration (for insertion as a new article of the UNCITRAL Model Law on International Commercial Arbitration, tentatively numbered 17 ter)**

### **A. Variants for consideration by the Working Group**

40. At its thirty-eighth session, the Working Group considered a possible draft provision expressing the power of the court to order interim measures of protection in support of arbitration on the basis of a Note by the Secretariat (A/CN.9/WG.II/WP.119) and, in particular, the draft provision which read as follows:

"The court shall have the same power of issuing interim measures of protection for the purposes of and in relation to arbitration proceedings as it has for the purposes of and in relation to proceedings in the courts."

41. General support was expressed in favour of a provision that would give a court power to issue interim measures of protection, irrespective of the country where the arbitration took place. It was pointed out that the scope of the provision was not in line with the rule on territoriality expressed in the Model Law. It was generally agreed that in preparing the revised draft, attention should be given to the possible need of adapting article 1 (2) to extend the exception to the territorial application of the Model Law (A/CN.9/524, para. 78). The Working Group may wish to consider amending article 1(2) to include a reference to any provision conferring upon a court the power to issue interim measures of protection even if the arbitration took place outside the country of that court.

42. The following variants are presented to assist a continuation of discussion on this topic.

#### *Variant 1*

"The court shall have the same power of issuing interim measures of protection for the purposes of and in relation to arbitration proceedings as it has for the purposes of and in relation to proceedings in the courts and shall exercise that power in accordance with its own rules and procedures insofar as these are relevant to the specific features of an international arbitration.

*Variant 2*

“The court shall have the same power of issuing interim measures of protection for the purposes of and in relation to arbitration proceedings as it has for the purposes of and in relation to proceedings in the courts. That power shall be exercised in accordance with the requirements set out under article 17 insofar as these requirements can be applied.”

43. The variants take a different approach as to the criteria and standards that apply to court-ordered interim measures. Variant 1 seeks to give effect to the suggestion that the court should apply its own rules of procedures and standards. Variant 2 reflects the view that the criteria and standards set forth in article 17 should apply to courts. It was generally recognized that any reference to existing standards would have to provide flexibility for the court to adapt to the specific features of international arbitration (A/CN.9/524, para. 77).

**B. Materials as examples to assist in the discussions**

44. The Working Group may wish to consider the following national legislation which provides different approaches to the question of whether to confer a power on courts to order interim measures of protection. Essentially, the issues raised in drafting such a provision include: whether this power should be limited only to arbitral tribunals or whether this power should be one that can be exercised by both an arbitral tribunal and a court. In the latter option, the issues that should be considered are how to balance the power to order interim measures of protection as between the courts and arbitral tribunals, namely: whether the power of the court should be limited to circumstances where the arbitral tribunal has not yet been constituted; whether an application to a court for interim measures should be subject to party consent and notice to the arbitral tribunal; whether the court power should be a secondary option available only where an arbitrator cannot act effectively or the parties have agreed that the arbitrator not be empowered to grant interim measures of protection. Alternatively the balancing of these powers could be left to party choice (for an earlier discussion on court-ordered interim measures, see A/CN.9/WG.II/WP.119, paras. 19-33, 37-40, 44-48 and 75-82).

**1. UK Arbitration Act 1996 (which applies to England and Wales Only)**

“44. - (1) Unless otherwise agreed by the parties, the court has for the purposes of and in relation to arbitral proceedings the same power of making orders about the matters listed below as it has for the purposes of and in relation to legal proceedings.

(2) Those matters are:

- (a) The taking of the evidence of witnesses;
- (b) The preservation of evidence;
- (c) Making orders relating to property which is the subject of the proceedings or as to which any question arises in the proceedings:
  - (i) For the inspection, photographing, preservation, custody or detention of the property, or

- (ii) Ordering that samples be taken from, or any observation be made of or experiment conducted upon, the property;

And for that purpose authorising any person to enter any premises in the possession or control of a party to the arbitration;

- (d) The sale of any goods the subject of the proceedings;
- (e) The granting of an interim injunction or the appointment of a receiver.

(3) If the case is one of urgency, the court may, on the application of a party or proposed party to the arbitral proceedings, make such orders as it thinks necessary for the purpose of preserving evidence or assets.

(4) If the case is not one of urgency, the court shall act only on the application of a party to the arbitral proceedings (upon notice to the other parties and to the tribunal) made with the permission of the tribunal or the agreement in writing of the other parties.

(5) In any case the court shall act only if or to the extent that the arbitral tribunal, and any arbitral or other institution or person vested by the parties with power in that regard, has no power or is unable for the time being to act effectively.

(6) If the court so orders, an order made by it under this section shall cease to have effect in whole or in part on the order of the tribunal or of any such arbitral or other institution or person having power to act in relation to the subject-matter of the order.

(7) The leave of the court is required for any appeal from a decision of the court under this section.”

## **2. German Arbitration Law—Section 1033 (Code of Civil Procedure)**

“Arbitration agreement and interim measures by court

It is not incompatible with an arbitration agreement for a court to grant, before or during arbitral proceedings, an interim measure of protection relating to the subject-matter of the arbitration upon request of a party.”

## **3. Hong Kong Arbitration Ordinance (Chapter 341 of the Law of Hong Kong)**

“(1) The Court or a judge of the Court may, in relation to a particular arbitration proceeding, do any of the following:

- (a) Make an order directing an amount in dispute to be secured;
- (b) In relation to relevant property:
  - (i) Make an order directing the inspection, photographing, preservation, custody, detention or sale of the property by the tribunal, a party to the proceedings or an expert; or
  - (ii) Make an order directing samples to be taken from, observations to be made of, or experiments to be conducted on the property;

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(c) Grant an interim injunction or direct any other interim measure to be taken.

(2) Property is relevant property for the purposes of subsection (1)(b) if:

(a) The property is owned by or is in the possession of a party to the arbitration proceedings concerned; and

(b) The property is subject to the proceedings, or any question relating to the property has arisen in those proceedings.

(3) The Court or a judge of the Court may order a person to attend proceedings before an arbitral tribunal to give evidence or to produce documents or other material evidence.

(4) The Court or a judge of the Court may also order a writ of habeas corpus ad testificandum to be issued requiring a prisoner to be taken for examination before an arbitral tribunal.

(5) The powers conferred by this section can be exercised irrespective of whether or not similar powers may be exercised under section 2GB in relation to the same dispute.

(6) The Court or a judge of the Court may decline to make an order under this section in relation to a matter referred to in subsection (1) on the ground that:

(a) The matter is currently the subject of arbitration proceedings; and

(b) The Court or the judge considers it more appropriate for the matter to be dealt with by the relevant arbitral tribunal.”

**C. Report of the Working Group on Arbitration on the work of its  
fortieth session (New York, 23-27 February 2004)  
(A/CN.9/547) [Original English]**

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## I. Introduction

1. At its thirty-second session (Vienna, 17 May-4 June 1999), the Commission generally considered that the time had come to, inter alia, evaluate in the universal forum of the Commission the acceptability of ideas and proposals for the improvement of arbitration laws, rules and practices. The Commission entrusted the work to the Working Group on Arbitration and decided that the priority items for the Working Group should include, among other matters, enforceability of interim measures of protection. The Working Group's deliberations on the topic of interim measures of protection began at its thirty-second session (Vienna, 21-30 March 2000), when the Working Group expressed general support for a legal regime governing enforcement of interim measures of protection ordered by the arbitral tribunal (A/CN.9/468, paras. 60-79). At that session, the Working Group also undertook a preliminary analysis of whether there was a need for a uniform rule on court-ordered interim measures of protection in support of arbitration (A/CN.9/468, paras. 85-87).

2. The Working Group agreed, at its thirty-third session (Vienna, 20 November-1 December 2000), that the proposed new article to the UNCITRAL Model Law on International Commercial Arbitration ("the UNCITRAL Model Law") on enforcement of interim measures of protection (tentatively numbered article 17 bis) should include an obligation on courts to enforce interim measures if prescribed conditions were met (see A/CN.9/485, paras. 78-106). At its thirty-fourth session (New York, 21 May-1 June 2001), in addition to continuing its review of draft article 17bis, the Working Group proceeded to consider a text revising article 17 of the UNCITRAL Model Law, which defined the scope of an arbitral tribunal's power to order interim measures and included an additional provision on the granting of interim measures on an *ex parte* basis (see A/CN.9/487, paras. 64-76). Discussions in relation to revised drafts of article 17 and 17 bis of the UNCITRAL Model Law continued at the thirty-sixth (New York, 4-8 March 2002) (see A/CN.9/508, paras. 51-94), thirty-seventh (Vienna, 7-11 October 2002) (see A/CN.9/523, paras. 15-76, 78-80), thirty-eighth (New York, 12-16 May 2003) (see A/CN.9/524, paras. 16-75) and thirty-ninth (Vienna, 10-14 November 2003) (see A/CN.9/545, paras. 19-112) sessions of the Working Group. The Secretariat was asked to prepare a revised version of these texts for consideration by the Working Group at its fortieth session.

3. The Working Group on Arbitration which was composed of all States members of the Commission, held its fortieth session in New York, from 23 to 27 February 2004. The session was attended by the following States members of the Working Group: Austria, Brazil, Burkina Faso, Cameroon, Canada, China, Colombia, Fiji, France, Germany, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Mexico, Morocco, Paraguay, Russian Federation, Sierra Leone, Singapore, Spain, Sweden, Thailand, Uganda, United Kingdom of Great Britain and Northern Ireland and United States of America.

4. The session was attended by observers from the following States: Albania, Belarus, Congo, Croatia, Cuba, Denmark, Egypt, Finland, Gabon, Ireland, Libyan Arab Jamahiriya, Madagascar, Malaysia, Myanmar, Pakistan, Peru, Philippines, Poland, Qatar, Republic of Korea, Serbia and Montenegro, South Africa, Switzerland, Timor Leste, Turkey, United Republic of Tanzania, Venezuela and Viet Nam.

5. The session was also attended by a non-member State maintaining observer mission at Headquarters: Holy See.
6. The session was also attended by observers from the following intergovernmental organizations: International Cotton Advisory Committee (ICAC), NAFTA Article 2022 Advisory Committee and the Permanent Court of Arbitration.
7. The session was also attended by observers from the following international non-governmental organizations invited by the Commission: American Arbitration Association (AAA), Association Suisse de l'Arbitrage (ASA), Association of the Bar of the City of New York (ABCNY), Cairo Regional Centre for International Commercial Arbitration, Center for International Legal Studies, Club of Arbitrators of the Milan Chamber of Arbitration, Global Center for Dispute Resolution Research, International Chamber of Commerce (ICC), International Council for Commercial Arbitration (ICCA), Regional Centre for International Commercial Arbitration (Lagos, Nigeria), School of International Arbitration and Union des Avocats Européens.
8. The Working Group elected the following officers:
  - Chairman:* Mr. José María ABASCAL ZAMORA (Mexico)
  - Rapporteur:* Mr. Sundaresh MENON (Singapore).
9. The Working Group had before it the following documents: (a) provisional agenda (A/CN.9/WG.II/WP.126); (b) a revised draft provision on enforcement and recognition of interim measures of protection pursuant to the decisions made by the Working Group at its thirty-eighth session (A/CN.9/WG.II/WP.125); (c) a note by the Secretariat containing a newly revised text of a draft provision on the power of an arbitral tribunal to order interim measures pursuant to the decisions made by the Working Group at its thirty-ninth session (A/CN.9/WG.II/WP.128); (d) a note by the Secretariat containing the information communicated by the delegations on the liability regime in the context of interim measures of protection (A/CN.9/WG.II/WP.127); (e) a proposal by the International Chamber of Commerce on articles 17 and 17 bis (A/CN.9/WG.II/WP. 129); and (f) the reports of the Working Group on its thirty-eighth and thirty-ninth sessions (A/CN.9/524 and 545).
10. The Working Group adopted the following agenda:
  1. Scheduling of meetings.
  2. Election of officers.
  3. Adoption of the agenda.
  4. Preparation of uniform provisions on interim measures of protection for inclusion in the UNCITRAL Model Law on International Commercial Arbitration.
  5. Other business.
  6. Adoption of the report.



## II. Summary of deliberations and decisions

11. The Working Group discussed agenda item 4 on the basis of the text contained in the notes prepared by the Secretariat (A/CN.9/WG.II/WP. 125, 127 and 128) and the proposal by the International Chamber of Commerce (A/CN.9/WG.II/WP. 129). The deliberations and conclusions of the Working Group with respect to that item are reflected in chapters III and IV below. The Secretariat was requested to prepare a revised draft of a number of provisions, based on the deliberations and conclusions of the Working Group.

## III. Draft provision on the recognition and enforcement of interim measures of protection (for insertion as a new article of the UNCITRAL Model Law on International Commercial Arbitration, tentatively numbered 17 bis)

12. The Working Group recalled that it had commenced considering a newly revised version of the provision on recognition and enforcement of interim measures of protection (hereinafter referred to as “draft article 17 bis”) at its thirty-ninth session (Vienna, 10-14 November 2003) (see A/CN.9/545, paras. 93-112). The Working Group proceeded to continue its discussion of article 17 bis which read as follows (as set out in para. 4 of A/CN.9/WG.II/WP.125 and reproduced in para. 94 of A/CN.9/545):

“(1) An interim measure of protection issued by an arbitral tribunal, that satisfies the requirements of article 17, shall be recognized as binding and, unless otherwise provided by the arbitral tribunal, enforced upon application [in writing] to the competent court, irrespective of the country in which it was issued, subject to the provisions of this article.\*

“(2) The court may only refuse to recognize [and] [or] enforce an interim measure of protection:

“(a) If, at the request of the party against whom it is invoked, the court is satisfied that:

“(i) *Variant 1:* There is a substantial issue as to the jurisdiction of the tribunal [[of such a nature as to make recognition or enforcement inappropriate] [of such a nature as to make the interim measure unenforceable]] [and no appropriate security was ordered by the arbitral tribunal in respect of that interim measure];

*Variant 2:* There is a substantial question relating to any grounds for such refusal set forth in article 36, paragraphs (1) (a) (i), (iii) or (iv); or

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\* The conditions set forth in this article are intended to limit the number of circumstances in which the court may refuse to enforce an interim measure of protection. It would not be contrary to the level of harmonization sought to be achieved by these model provisions if a State were to adopt fewer circumstances in which enforcement may be refused.

“(ii) *Variant 1*: That party was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings [, in which case the court may suspend the enforcement proceedings [until the parties have been heard by the arbitral tribunal] [until the parties have had an opportunity to be heard by the arbitral tribunal] [until the parties have been properly notified]]];

*Variant 2*: Such refusal is warranted on the grounds set forth in article 36, paragraph (1) (a) (ii); or

“(iii) *Variant 1*: That party was unable to present its case with respect to the interim measure [in which case the court [may] [shall] suspend the enforcement proceedings until the parties have been heard by the arbitral tribunal]; or

*Variant 2*: Such refusal is warranted on the grounds set forth in article 36, paragraph (1) (a) (ii); or

“(iv) The interim measure has been terminated or suspended by the arbitral tribunal or by order of a competent court; or

“(b) If the court finds that:

“(i) The interim measure requested is incompatible with the powers conferred upon the court by its laws, unless the court decides to reformulate the interim measure to the extent necessary to adapt it to its own powers and procedures for the purposes of enforcing that interim measure and without modifying its substance; or

“(ii) *Variant 1*: The recognition or enforcement of the interim measure would be contrary to the public policy recognized by the court.

*Variant 2*: Any of the grounds set forth in article 36, paragraphs (1) (b) (i) or (ii) apply to the recognition and enforcement of the interim measure.

“(3) Any determination made by the court on any ground in paragraph (2) of this article shall be effective only for the purposes of the application to recognize and enforce the interim measure of protection.

“(4) The party who is seeking or has obtained enforcement of an interim measure of protection shall promptly inform the court of any termination, suspension or amendment of that interim measure.

“(5) *Variant A*: The court where recognition or enforcement is sought may, if it considers it proper, order the other party to provide appropriate security for costs [unless the tribunal has already made an order with respect to security for costs] [unless the tribunal has already made an order with respect to security for costs, except when the court finds that the order is inappropriate or insufficient in the circumstances].

*Variant B*: The court where recognition or enforcement is sought may, if it considers it proper, order security for costs.

*Variant C:* The court where recognition or enforcement is sought shall not, in exercising that power, undertake a review of the substance of the interim measure of protection.

*Variant D:* The court where recognition or enforcement is sought may only order security for costs where such an order is necessary to protect the rights of third parties.

“(6) Paragraph (2) (a) (ii) does not apply.

*Variant X:* To an interim measure of protection that was ordered without notice to the party against whom the interim measure is invoked provided that the interim measure was ordered to be effective for a period not exceeding [thirty] days and the enforcement of the interim measure is requested before the expiry of that period.

*Variant Y:* To an interim measure of protection that was ordered without notice to the party against whom the interim measure is invoked provided that such interim measure is confirmed by the arbitral tribunal after the other party has been able to present its case with respect to the interim measure.

*Variant Z:* If the arbitral tribunal, in its discretion, determines that, in light of the circumstances referred to in article 17 (2), the interim measure of protection can be effective only if the enforcement order is issued by the court without notice to the party against whom the interim measure is invoked.”

### General remarks

13. The Working Group recalled that, at its thirty-ninth session, it had reached a number of decisions in respect of draft article 17 bis, namely to delete the bracketed text “in writing” from draft paragraph (1) (A/CN.9/545, para. 96), to delete the reference to the words “that satisfies the requirements of article 17” from draft paragraph (1) and to add another ground on which the court might refuse to recognize and enforce an interim measure under paragraph (2) (A/CN.9/545, para. 102 and also paras. 107-110). As well, the Working Group recalled that it had found the substance of the footnote to paragraph 1 to be generally acceptable (A/CN.9/545, para. 97).

14. The view was expressed that the text of draft article 17 bis was problematic and unnecessarily complex. On that basis, an alternative text was proposed in the following terms (hereafter “the proposed shorter draft”):

“(1) An interim measure of protection issued by an arbitral tribunal shall be recognized as binding and [unless otherwise provided by the arbitral tribunal] enforced upon application to the competent court, irrespective of the country in which it was issued.

“(2) The competent court may refuse to recognize [and] [or] enforce an interim measure of protection only if:

“(a) Upon the request of the party against whom the measure is directed, the court is satisfied that:

“(i) The party was not given proper notice of the appointment of an arbitrator or of the arbitral proceedings;

“(ii) The party against whom the measure is directed was unable to present its case under the conditions of article 17;

“(iii) The arbitral tribunal was not entitled to order an interim measure of protection.

“(3) The court finds that:

“(a) The interim measure is incompatible with the powers conferred upon the court by its laws, unless the court decides to reformulate the interim measures in order to adapt it with its powers.

“(b) The recognition or enforcement of the interim measure would be contrary to the public policy recognized by the court.”

15. It was stated that the proposed shorter draft provided greater clarity and also avoided the possibility of creating rules for the recognition and enforcement of interim measures that were stricter than the rules governing recognition and enforcement of an award on the merits of the case. Some support was expressed for the proposed shorter draft on the basis that it was concise and set forth rules that were specifically geared to the recognition and enforcement of interim measures, as opposed to the text of draft article 17 bis, which essentially mirrored rules established in the New York Convention in respect of the recognition and enforcement of arbitral awards.

16. However, reservations were expressed against the general policy reflected in the proposed shorter draft, which was said to exclude a number of important details that were set out in draft article 17 bis. It was recalled that the Working Group had earlier agreed that, given the difference between the characteristics of interim measures and those of final awards, interim measures ought to be treated differently from awards. It was stated that one reason for that distinction was that interim measures, unlike final awards, could be changed during the course of the arbitral proceeding. Thus, in expressing the rules to be followed by courts in enforcing such measures, the Working Group had agreed that it was important to accommodate this distinctive temporary character. As well, it was stated that the proposed shorter draft did not address matters such as security (as addressed in para. (2) (a) (i) of draft article 17 bis) or the obligation to inform the court of any termination, suspension or amendment of that interim measure (as addressed by para. (4) of draft article 17 bis).

#### **Paragraph (1)**

17. The Working Group noted that the text in paragraph (1) of draft article 17 bis and the proposed shorter draft were substantially the same and the former text should be adopted with the deletions referred to in paragraph 13 above.

#### **Paragraph (2) (a)**

##### *Subparagraph (a) (i)*

18. The Working Group recalled that, at its thirty-ninth session, of the two variants included in the draft subparagraph, preference was expressed for the

retention of Variant 2 (A/CN.9/545, paras. 105-106). It was suggested that the variant reflected the policy of the Working Group to bring the grounds for refusing enforcement of an interim measure issued by an arbitral tribunal somewhat closer to the grounds listed in articles 35 and 36 of the Model Law and those listed in article V of the New York Convention for refusing enforcement of an award (see A/CN.9/WGII/WP.125, para. 12 and A/CN.9/524, para. 57).

19. It was generally agreed that Variant 2 should be adopted, since that variant contained a straightforward reference to article 36, instead of replicating the contents of article 36 with slight changes, as did Variant 1, in a way that was described as likely to generate ambiguity and confusion. As a matter of drafting, a suggestion was made that the words “for such refusal” should be deleted, since they could be misinterpreted as referring to a refusal to recognize or enforce a final arbitral award under article 36. It was generally felt that the text should indicate more clearly that the reference to refusal was to the refusal to recognize or enforce an interim measure. To clarify that point it was agreed to delete the word “such”.

20. A reservation was expressed as to the use of the words “there is a substantial question” and it was suggested that, for the sake of consistency and clarity it would be better to mirror the language used elsewhere in draft paragraph 17 bis, namely, “Such refusal is warranted on the grounds”.

21. A suggestion was made that reference should be made to the question of security which was expressly addressed in Variant 1 but not in Variant 2. Strong support was expressed for the idea that, if an order for security made by the arbitral tribunal had not been complied with, such non-compliance should be a ground for the court refusing enforcement of the interim measure. It was agreed that the idea should be reflected at an appropriate place in the text of draft article 17 bis, possibly in paragraph (5).

*Subparagraph (a) (ii)*

22. The Working Group considered Variants 1 and 2 of subparagraph (a) (ii). It was pointed out that Variant 1 contained a mechanism, which was not reflected under article 36 (1) (a) (ii) of the Model Law, in that it allowed for suspension of the enforcement of an interim measure until proper notification was made to the parties. However, for the sake of consistency with the approach already agreed to by the Working Group that the legal framework for enforcement of interim measures should be similar to that existing for the enforcement of arbitral awards under article 36 of the Model Law, the Working Group agreed to retain Variant 2, without modification.

*Subparagraph (a) (iii)*

23. The Working Group agreed to retain Variant 2 of subparagraph (a) (iii).

24. As the Working Group had agreed to retain reference to article 36 (1) (a) (i), (ii), (iii) and (iv) of the Model Law under paragraph 2 (a) of draft article 17 bis, the question whether to merge subparagraphs (i), (ii) and (iii) of that paragraph was considered. It was agreed that subparagraphs (a) (ii) and (iii) should be merged. The view was expressed that it was crucial that the power of the arbitral tribunal to decide its own jurisdiction should be preserved and that courts should not pre-empt determination by the arbitral tribunal of its competence in the first instance. For that

reason, it was suggested that the wording under Variant 2 of paragraph (a) (i) should be maintained as currently drafted. In that context, it also was suggested that, when discussing paragraph (3) of draft article 17 bis, the Working Group might need to review the various grounds for refusing enforcement set forth in article 36 (1) (a) (ii) of the Model Law, to avoid suggesting that the decision made when a court was called upon to enforce an interim measure (for example, a decision as to whether the party against whom the interim measure was invoked had received proper notice of the appointment of the arbitrator) could have an effect beyond the limited sphere of recognition and enforcement of the interim measure.

*Subparagraph (a) (iv)*

*Distinction between subparagraph (iv) and article 36 (1) (a) (v) of the Model Law*

25. A suggestion was made that the text of subparagraph (iv) should be replaced by a reference to article 36(1) (a) (v) of the Model Law. It was pointed out in response that such a reference would be misleading, since those two provisions served two different purposes and referred to two different situations. Article 36 (1) (a) (v) of the Model Law was intended to refer to the situation where a final award had been set aside or was subject to some form of appeal under the law under which it was made. By contrast, subparagraph (iv) reflected the ephemeral nature of an interim measure, which could be suspended or terminated by the arbitral tribunal itself.

*Effect of subparagraph (iv)*

26. A question was raised as to whether the effect of subparagraph (iv) would be to allow the court to set aside an interim measure issued by the arbitral tribunal. In response, it was recalled that, at its previous session, the Working Group had decided to delete the general reference to the requirements of article 17 from paragraph (1), precisely to avoid creating an additional and hidden ground for the refusal to recognize and enforce an interim measure (A/CN.9/545, paras. 101-102). It had been agreed that the enforcing court should not be required or encouraged to undertake a review *de novo* of whether the interim measure satisfied the requirements of article 17 (*ibid.*, para. 99). The Working Group reaffirmed that decision in the context of subparagraph (iv), which should not be misinterpreted as creating a ground for the court to set aside the interim measure issued by the arbitral tribunal. It was recalled that the general purpose of article 17 bis was to establish rules for the recognition and enforcement of interim measures, but not to parallel article 34 of the Model Law with provisions on setting aside such interim measures. A suggestion was made that the issue of whether an interim measure issued in the form of an award could be set aside under article 34 of the Model Law might require further consideration by the Working Group. The Working Group took note of that suggestion.

27. In the context of that discussion, it was widely felt that the operation of subparagraph (iv) should be considered both from the perspective of a country having enacted the Model Law and from that of a country whose legislation was not based on that model. In particular, since no direct link existed between articles 17 and 17 bis, no implication should be made that the operation of article 17 bis would presuppose the existence of a provision along the lines of article 17. Along the same lines, an effort should be made to avoid the implication that court recognition and

enforcement of an interim measure ordered by an arbitral tribunal would be available only where the interim measure had been issued by an arbitral tribunal operating under the Model Law.

*“Or by order of a competent court”*

28. The Working Group proceeded to consider whether the reference to a situation where an interim measure had been set aside “by a competent court” was necessary. It was recalled that article 5 of the Model Law provided that “in matters governed by this Law, no court shall intervene except where so provided in this Law”. Accordingly, legislation in countries having adopted the Model Law would not empower courts to proceed with a review of compliance of an interim measure with article 17. However, a widely held view was that article 17 bis should provide a rule for the situation where the interim measure was issued under the law of a country that had not adopted the Model Law and that law permitted courts to review the interim measure issued by the arbitral tribunal for possible setting aside.

29. One consequence of that situation was that courts operating under article 17 bis might be faced with the case where an interim measure would be presented for enforcement, even if it had been set aside by a court in another country. It was widely agreed that, in such a situation where the interim measure had been set aside in its country of origin, the courts of the enacting State should be permitted to refuse recognition and enforcement. It was also agreed that, since article 17 bis provided an exhaustive set of grounds for refusing recognition and enforcement, that situation should be addressed in that article.

30. Various suggestions were made as to how that situation should be addressed. One suggestion was made to amend subparagraph (a) (iv) in such a manner that it would not mention the body which had terminated or suspended the interim measure. Under that suggestion, subparagraph (iv) would read along the following lines: “The interim measure has been terminated or suspended”. A concern was expressed that this wording would encourage forum shopping.

31. Another suggestion, based on the proposed shorter draft, was to delete subparagraph (iv) altogether. It was explained that there was no need to deal expressly with the suspension or termination of an interim measure by an arbitral tribunal, since no ground could be invoked for the recognition and enforcement of such a measure, and no need for specific provisions on setting aside of the interim measure by a competent court, since such setting aside would be governed by applicable rules of domestic procedural law. No support was expressed for that suggestion.

32. Yet another suggestion was that subparagraph (iv) should be amended along the following lines:

“(iv) The interim measure has been terminated or suspended by the arbitral tribunal or, where so empowered, by a court of the country in which, or under the law of which, that interim measure was granted.”

33. Although doubts were expressed about the manner in which the amended text would operate in practice, that suggestion was found generally acceptable for continuation of the discussion at a later stage. It was observed that the words “or

under the law of which, that interim measure was granted” might need to be replaced by a reference to the country of the seat of the arbitral tribunal.

*Proposals for including additional provisions under paragraph (2) (a)*

*Arbitral tribunal not entitled to issue an interim measure*

34. At its previous session, the Working Group had taken note of a proposal to add a ground on which the court might refuse to recognize and enforce an interim measure, based on the arbitral tribunal being prohibited from issuing the interim measure, as a result of either the agreement of the parties or the law of the country where the arbitration took place (A/CN.9/545, para. 107). At the current session, support was expressed for retaining such an additional ground. Along the same lines, the proposed shorter draft was considered. In support of retaining a provision along those lines, it was stated that the addition was necessary as a result of the deletion of the reference to the requirements of article 17 in paragraph (1). It was also stated that the issue was not sufficiently covered by the reference to article 36 (1) (a) (iv) of the Model Law, which referred to procedural issues, and not to the *lex arbitri*. The proposal was objected to on the grounds that it could open the door to a review on the merits of the case by courts. Preference was expressed for not including the proposed additional wording, since the issue was considered to be sufficiently covered by the reference to article 36(1) (a) and the choice of Variant 2 under subparagraphs (a) (i), (ii) and (iii).

*Jurisdictional immunities of States*

35. It was proposed to consider inserting a provision on the issue of jurisdictional immunities of States and their property, based on a proposal made during the previous session in the context of the discussion of article 17 (A/CN.9/545, para. 51). It was observed that this question might need to be considered more broadly, for example in the context of possible future work by UNCITRAL, but that it should not be debated in the limited context of interim measures.

**Paragraph (2) (b)**

*Subparagraph (b) (i)*

36. The Working Group found the substance of subparagraph (b) (i) to be generally acceptable.

*Subparagraph (b) (ii)*

37. The Working Group proceeded to consider the two Variants contained in paragraph (b) (ii). A widely shared view was that Variant 2 should be retained, since it was consistent with the approach adopted under paragraph (2) (a). It was pointed out that Variant 1 contained wording that differed slightly from that of article 36 (1) (b) (ii) of the Model Law in a manner that might be difficult to interpret. For example, subparagraph (b) (ii) referred to the “public policy recognised by the court”, whereas article 36 (1) (b) (ii) of the Model Law referred to the “public policy of this State”. It was said that referring to the “public policy of that State” was preferable to a reference to “public policy recognised by the court”, as this latter wording might be understood as conferring excessive powers upon the court.



38. The question was raised whether reference should be made to both subparagraphs (i) and (ii) of article 36 (1) (b) of the Model Law, or whether the matters covered under these two provisions, namely arbitrability and public policy, should receive separate treatment under article 17 bis.

39. A suggestion was made that the reference to subparagraph (i) of article 36 (1) (b) of the Model Law should be excluded from paragraph (b) (ii). In support of that suggestion, it was said that, at the time when enforcement of an interim measure was sought, a court might not be able to fully determine the subject matter of the dispute. Therefore, allowing a court to make a decision on the arbitrability of the subject matter in dispute might not be appropriate at that stage of the procedure. However, it was said that, when the matter of the dispute was clearly established, and when that subject matter was not capable of settlement by arbitration under the law of the enforcing State, it would be inconsistent for State courts in that context, to enforce such an interim measure. Therefore, it was proposed that, instead of removing any reference to subparagraph (i) of article 36 (1) (b) of the Model Law, Variant 2 should be revised along the lines of paragraph 2 (a) (i), i.e. “There is a substantial question relating to any grounds for such refusal set forth in article 36 (1) (b) (i) or (ii)”.

40. The view was expressed that the concerns expressed about determining arbitrability at the point of enforcement was already addressed by paragraph (3), which ensured that any determination by a court to enforce an interim measure was effective only for the purpose of the application to recognize and enforce the interim measure.

41. After discussion, the Working Group adopted the text of Variant 2 without modification, subject to further consideration of the wording used in relation to references to article 36 (1) (a) and (b) of the Model Law in paragraphs (2) (a) and (b) after the Working Group had completed its review of article 17 bis.

42. At the close of the discussion, the Working Group took note of the view that, in any case, the reference in subparagraph (ii) to article 36 (1) (b) (i) of the Model Law should not be interpreted as obliging the court to request information on the subject matter in dispute to determine questions of arbitrability.

43. It was observed that, in paragraph (2), the Working Group had maintained reference to article 36 (1) of the Model Law and that that article spoke in terms of awards. Given that the Working Group had taken the decision not to define the form in which an interim measure should be made, a suggestion was made to clarify that the term “award” under article 36 (1) should be interpreted as covering all types of interim measures, with no implied restriction that the grounds in article 36 (1) applied only to those interim measures issued in the form of an award.

44. It was said that in preparing a revised draft for further consideration by the Working Group, the Secretariat should seek to produce a consolidated text with wording in harmony with that used in the Model Law. For example, it was said that in the phrase “the powers conferred upon the court by its laws” under paragraph 2 (b) (i), the reference to “by its law” should be replaced by a reference to either “the law” or “procedural rules”.

*Possible additional grounds for refusing recognition and enforcement*

45. The Working Group considered whether any other grounds for refusing recognition and enforcement of an interim measure should be added under paragraph (2). The Working Group recalled the suggestion that, if an order for security made by the arbitral tribunal had not been complied with, such non-compliance should be a ground for the court to refuse enforcement of the interim measure (see above, para. 21). Strong support was expressed for that suggestion. It was recalled that the consequences of non-compliance with an order for security should be reflected at an appropriate place in the text of draft article 17 bis.

46. Against including non-compliance with an injunction to provide security to the list contained in paragraph (2), it was said that article 17 (4) of the Model Law ensured that, if an arbitral tribunal decided to order that the party seeking the measure provided security, such condition should be interpreted as a condition precedent to the granting of the measure.

47. It was suggested that this interpretation of article 17 (4) was not consistent with the practical approach that an arbitral tribunal might adopt in ordering an interim measure. It was said that whilst an interim measure might need to take immediate effect, the arbitral tribunal could, in the order for security, allow a period of time for the requesting party to organize the provision of the security. To address that practical reality, it was suggested that the provision of security should be interpreted as encompassing a condition subsequent under article 17 (4), and not merely a condition precedent.

48. It was said that, where the interim measure had been granted, but the security had not been provided as requested by the arbitral tribunal, the current draft of paragraph (2) of article 17 bis did not allow a court to refuse recognition and enforcement. It was suggested that this matter should be addressed under both paragraph (4) of draft article 17 and paragraph (2) of article 17 bis, as these two articles might be applied independently by national courts.

**Paragraph (3)**

49. The Working Group found the substance of paragraph (3) to be generally acceptable.

50. It was suggested that Variant C of paragraph (5), which expressed the important principle that the court where enforcement of the interim measure was sought should not review the substance of the interim measure, should be included in paragraph (3). The Working Group agreed to further consider this matter when reviewing paragraph (5).

**Paragraph (4)**

51. It was recalled that paragraph (4) was based on the principle that a party seeking enforcement of an interim measure should be obliged to inform the court of any termination, suspension or amendment of that measure. It was recalled that broad support had been expressed by the Working Group for that principle at its thirty-eighth session (A/CN.9/524, paras. 35-39).

52. The relevance of the paragraph was questioned. It was suggested that if the interim measure had been suspended or terminated, the enforcement procedure itself

no longer served any purpose. Instead of requesting the party who had sought or obtained the interim measure to inform the court of any termination, suspension or amendment of the interim measure, it was suggested that it would be preferable to request a court not to enforce such an interim measure. No support was expressed for that suggestion.

53. The Working Group found the substance of paragraph (4) to be generally acceptable. As a matter of drafting, the view was expressed that there appeared to be a discrepancy between the language used in paragraph (4), which referred to “termination, suspension or amendment”, and the language used earlier in the text in paragraph (2) (a) (iv), which referred only to “terminated or suspended”. It was suggested that the draft provision should be revised to achieve greater consistency in the overall text. It was further suggested that the omission of the term “recognition” from paragraph (4) appeared to be inconsistent with the language used in other provisions of the text. The Working Group agreed that these matters of drafting should be further considered in the final stages of the preparation of draft article 17 bis.

### **Paragraph (5)**

54. The Working Group recalled that paragraph (5) dealt with the important question of whether, and to what extent, a court, when faced with an application to enforce an interim measure, ought to be able to order the applicant to provide security. That provision had been the subject of discussion at its thirty-eighth session (A/CN.9/524, paras. 72-75). It was further recalled that the four variants, Variants A to D, reflected the differing views expressed at its thirty-eighth session on that question.

#### *Variants A and B*

55. The view was expressed that Variant B and the second bracketed text of Variant A appeared to allow a court to second-guess an arbitral tribunal’s orders in respect of security. For that reason, Variant A and the first bracketed text, namely, “unless the tribunal had already made an order with respect to security for costs”, was to be preferred. Broad support was expressed for that view.

56. It was stated that, as a general principle, a court should not have the power to review the merits of a decision taken by an arbitral tribunal as to whether or not security should be ordered in respect of the granting of an interim measure. However, it was suggested that, as presently drafted, the first bracketed text could be understood to suggest that, if the tribunal had not considered it appropriate to issue an order for security, the court could still review that decision. It was said that if the policy of the Working Group was to entirely exclude the possibility of a court undertaking a review of a tribunal’s decision to grant or not grant security, then the language in Variant A needed to be clarified. To achieve such clarification, it was suggested that the words “an order” be replaced by the words “a determination” to emphasize that a court should not second-guess a tribunal’s determination on whether or not to grant security. That suggestion was adopted.

57. A suggestion was made that the possibility for the court to review *ex officio* the question of whether or not to grant security should not be completely excluded. In that respect, it was said that the approach taken in the second bracketed text of

Variant A, which allowed the court to make an order with respect to security for costs where it found that the order in that respect was “inappropriate or insufficient in the circumstances” was to be preferred. It was said that inclusion of this power for courts could in fact facilitate the enforcement of interim measures and also could provide courts with an additional opportunity to take account of the interests of third parties in making orders with respect to security. A contrary suggestion was that the text should clarify that the order to provide security should be made “at the request of the party against whom the interim measure is invoked” or “on the application of the party against whom the interim measure is directed or who is affected by the measure”. After discussion, those suggestions were not adopted by the Working Group.

*“Security for costs”*

58. It was agreed that the term “security for costs” was too narrow and should, consistently with the approach taken in draft article 17, be replaced by a reference to “security” or “appropriate security” as provided in paragraph (4) of draft article 17.

*“The other party”*

59. It was stated that there was uncertainty in the present text of paragraph (5) as to which party was referred to as “the other party”. It was explained that, in the context of certain situations involving multi-party arbitration, the party ordered to provide security might be distinct from the party requesting the interim measure. However, in view of the fact that, in most conceivable cases, the party ordered to provide security would be the party requesting the interim measure, the text should refer more clearly to the requesting party. It was proposed that the words “the other party” should be replaced by “the requesting party”. After discussion, the Working Group adopted that proposal.

*Variant C*

60. It was stated that Variant C supported the general philosophy that the grounds for refusing to recognize or enforce an interim measure should be restricted to procedural matters and exclude the possibility of the court reviewing the substance of the measure *de novo*. It was suggested that Variant C dealt with a broader issue than security for costs and should therefore be located in a separate article (see above, para. 50). After discussion, the Working Group decided that wording along the lines of Variant C should be placed as a second sentence in paragraph (3).

*Variant D*

61. It was stated that Variant D, being limited to orders necessary to protect the rights of third parties, was too narrow. It was suggested that interim measures ordered by an arbitral tribunal were only binding on the parties to the arbitral proceedings, whereas a court decision could have wider application and apply to third parties. It was suggested that Variant D dealt with an important issue of third-party protection, which could perhaps be built into Variant A. It was agreed that the Secretariat should consider an appropriate location to reflect the principle set forth in Variant D.

**Paragraph (6)**

62. It was recalled by the Working Group that, given the potential adverse impact of an *ex parte* measure against the affected party, empowering an arbitral tribunal to issue such an order would only be acceptable if strict conditions were imposed to ensure that the power was not subject to abuse (A/CN.9/523, para. 17).

63. Bearing that concern in mind, a proposed revised draft for paragraph (6) was made as follows:

“An interim measure issued by an arbitral tribunal under standards substantially equivalent to those set forth in paragraph (7) of article 17 will not be denied enforcement pursuant to paragraph 2 (a) (ii) of this article because of the measure’s *ex parte* status, provided that any court action to enforce such measure must be issued within twenty (20) days after the date on which the tribunal issued the measure”.

64. It was explained that the term “substantially similar” was proposed in order to take into account the slight variations that countries might introduce when adopting the Model Law. It was highlighted that the time frame of twenty days provided in the proposed draft related to the issuance of the court action to enforce the measure after the arbitral tribunal made the decision, and not, as in Variant X of the current draft, to the time limit within which a party might request a court to enforce an interim measure.

65. Among the Variants proposed for consideration by the Working Group in the current draft, Variant X was the preferred option. Support was also expressed for the proposed revised draft. The references to the safeguards laid down under article 17 were considered crucial by the Working Group.

66. Given the temporary nature of an *ex parte* interim measure, which would either lapse after twenty days or be converted into an *inter partes* measure, the necessity for including specific provisions for enforcement of *ex parte* interim measures contained in the proposal was questioned.

67. After discussion, the Working Group decided that the discussion on paragraph (6) would be continued on the basis of the proposed revised draft, which would be placed in square brackets, after the review of draft article 17 had been completed.

#### **IV. Draft article 17 of the UNCITRAL Model Law on International Commercial Arbitration regarding the power of an arbitral tribunal to grant interim measures of protection**

**General remarks**

68. Having completed a review of draft article 17 bis, the Working Group turned its attention to the newly revised draft of article 17 of the Model Law regarding the power of an arbitral tribunal to grant interim measures of protection contained in A/CN.9/WG.II/WP.128 in the following terms:

“(1) Unless otherwise agreed by the parties, the arbitral tribunal may, at the request of a party, grant interim measures of protection.

“(2) An interim measure of protection is any temporary measure, whether in the form of an award or in another form, by which, at any time prior to the issuance of the award by which the dispute is finally decided, the arbitral tribunal orders a party to:

“(a) Maintain or restore the status quo pending determination of the dispute;

“(b) Take action that would prevent, or refrain from taking action that is likely to cause, current or imminent harm;

“(c) Provide a [preliminary] means of [securing] [preserving] assets out of which a subsequent award may be satisfied; or

“(d) Preserve evidence that may be relevant and material to the resolution of the dispute.

“(3) The party requesting the interim measure of protection shall satisfy the arbitral tribunal that:

“(a) [Irreparable harm] is likely to result if the measure is not ordered, and such harm substantially outweighs the harm that is likely to result to the party against whom the measure is directed if the measure is granted; and

“(b) There is a reasonable possibility that the requesting party will succeed on the merits, provided that any determination on this possibility shall not affect the discretion of the arbitral tribunal in making any subsequent determination.

“(4) The arbitral tribunal may require the requesting party and any other party to provide appropriate security as a condition to granting an interim measure of protection.

“(5) The requesting party shall inform the arbitral tribunal promptly of any material change in the circumstances on the basis of which the party made the request for, or the arbitral tribunal granted, the interim measure of protection. All statements, documents or other information supplied to the arbitral tribunal by one party shall be communicated to the other party.

“(6) The arbitral tribunal may modify, suspend or terminate an interim measure of protection [it has granted], at any time, upon application of any party or, in exceptional circumstances, on the tribunal’s own initiative, upon prior notice to the parties.

“[(6 bis) The requesting party shall be liable for any costs and damages caused by the interim measure of protection to the party against whom it is directed from the date the measure has been granted and for as long as it is in effect [to the extent appropriate, taking into account all of the circumstances of the case, in light of the final disposition of the claims on the merits]. The arbitral tribunal may order an immediate award of damages.]

“(7) “(a) [Unless otherwise agreed by the parties] [If expressly agreed by the parties], the arbitral tribunal may [in exceptional circumstances,] grant an

interim measure of protection, without notice to the party against whom the measure is directed, [when] [if the requesting party shows that]:

“(i) There is an urgent need for the measure;

“(ii) [The conditions set out in paragraph (3) are met]; and

“(iii) The requesting party [shows] [satisfies the arbitral tribunal] that it is necessary to proceed in that manner in order to ensure that the purpose of the measure is not frustrated before it is granted;

“(b) The requesting party shall be liable for any costs and damages caused by the interim measure of protection to the party against whom it is directed from the date the measure has been granted and for as long as it is in effect [to the extent appropriate, taking into account all of the circumstances of the case, in light of the final disposition of the claims on the merits]. The arbitral tribunal may order an immediate award of damages;

“(c) The arbitral tribunal shall require the requesting party and any other party to provide appropriate security as a condition to granting an interim measure of protection;

“(d) *Variant 1:* The arbitral tribunal shall have jurisdiction, inter alia, to determine all issues arising out of or relating to subparagraph (b) [and (c)] above, [at any time during the arbitration proceedings];

*Variant 2:* A party may, at any time during the arbitration proceedings, bring a claim under subparagraph (b);

“(e) *Variant A:* The party against whom the interim measure of protection is directed shall be given immediate notice of the measure and an opportunity to present its case before the arbitral tribunal at the earliest possible time and in any event no later than [forty-eight] hours after that notice, or on such other date and time as is appropriate in the circumstances;

*Variant B:* Any party affected by the interim measure of protection granted under this paragraph shall be given immediate notice of the measure and an opportunity to present its case before the arbitral tribunal within [forty-eight] hours of the notice, or on such other date and time as is appropriate in the circumstances;

“(f) Any interim measure of protection ordered under this paragraph shall expire after twenty days from the date on which the arbitral tribunal orders the measure, unless that measure has been confirmed, extended or modified by the arbitral tribunal [, upon application by the requesting party and] after the party against whom the measure is directed has been given notice and an opportunity to present its case. All statements, documents or other information supplied to the arbitral tribunal by one party shall be communicated to the other party;

“(g) A party requesting an interim measure of protection under this paragraph shall [inform the arbitral tribunal of] [place before the arbitral tribunal information relating to] all circumstances that the arbitral tribunal is likely to find relevant and material to its determination [whether the

requirements of this paragraph have been met] [whether the arbitral tribunal should grant the measure].”

#### **Paragraph (1)**

69. The Working Group found the substance of paragraph (1) to be generally acceptable.

#### **Paragraph (2)**

*Chapeau “whether in the form of an award or in another form”*

70. It was suggested that the phrase “whether in the form of an award or in another form” should be deleted. It was stated that, in many legal systems, an interim measure would never take the form of an award and was most likely to be issued in the form of a procedural order. It was also stated that the reference to an award as the only expressed example of the form such a measure could take could create the false impression that an award was the most appropriate form for an interim measure. It was said that the inclusion of the term “award” in the definition of interim measure would be inappropriate to those jurisdictions whose legislation defined an award as a decision of the arbitral tribunal on the substance of the dispute. In addition, it was suggested that the deletion of the phrase from subparagraph (2) (b) would not take away from the effectiveness of the provision. A proposal was made to delete the phrase and replace it with more neutral words, such as “irrespective of the name and form of that measure”.

71. A contrary view was that the phrase should be maintained to acknowledge the fact that in some legal systems, in order to be recognized and enforced, an interim measure was required to be issued in the form of an award. As well, it was said that the phrase had been understood as being broad enough to encompass any interim measure, regardless of the title given to it. In support of retention of the phrase, it was said that the wording used to refer to the form of interim measures originated from the UNCITRAL Arbitration Rules and that the language was sufficiently neutral to reflect the intention of the Working Group not to create any preferred form in which an interim measure should be issued.

72. The Working Group recalled that these words had been the subject of discussion at its thirty-fifth session in 2002 (see A/CN.9/508, paras. 65-68) and thirty-sixth session in 2003 (see A/CN.9/523, para. 36) and that they had generally been accepted. After discussion, the Working Group decided not to modify the chapeau of paragraph (2). In the context of that discussion, it was suggested that any explanatory material to be prepared at a later stage, possibly in the form of a guide to enactment of draft article 17, should make it clear that the wording adopted regarding the form in which an interim measure might be issued should not be misinterpreted as taking a stand in respect of the controversial issue as to whether or not an interim measure issued in the form of an award would qualify for enforcement under the New York Convention.



*Subparagraph (c)**[Preliminary]*

73. The Working Group agreed to delete the word “preliminary” on the basis that it was confusing and added nothing to the meaning of the provision.

*[Securing] [preserving]*

74. The Working Group expressed its preference for the retention of the word “preserving” rather than “securing” because the latter term could be interpreted as a particular method for protecting assets. It was agreed to delete the word “securing” from the text and retain the word “preserving”.

*Anti-suit injunctions*

75. A question was raised whether paragraph (2) of article 17, as presently drafted, could be interpreted as encompassing a power of an arbitral tribunal to order an anti-suit injunction (i.e. an interim measure by which an arbitral tribunal would order a party not to pursue court proceedings or separate arbitral proceedings). In view of the fact that article 17 (2) contained a generic exhaustive list of provisional measures (see A/CN.9/545, para. 21), it was suggested that the Working Group should clarify whether it was its intention that this list should encompass the ordering of such an anti-suit injunction.

76. As a matter of general policy, reservations were expressed against article 17 directly or indirectly allowing the use of anti-suit injunctions. It was said that these types of injunctions were rather uncommon in international legal practice, unknown or not familiar to many legal systems, and, under some national laws, would be regarded as contradicting the fundamental constitutional right of a party to apply for court action. It was also stated that there might be a danger in proposing a specific provision to cover anti-suit injunctions and in descending into too much detail in this provision. Notwithstanding the express aim of the Working Group to promote harmonization in international arbitration law, there was a risk inherent in endorsing a juridical practice that was not yet settled. It was said that inclusion of such a provision might jeopardize the chances of it being implemented, or indeed jeopardize the overall acceptability of the Model Law, particularly in those countries that did not recognize anti-suit injunctions. From a different perspective, it was pointed out that, while the issue of anti-suit injunctions might be of growing importance in the practice of international arbitration, it deserved careful study, including possible consideration for the preparation of a discrete set of rules by UNCITRAL, but that it should not be dealt with in an indirect and incomplete manner in the context of a provision dealing with interim measures of protection, which might not do justice to the issue and lead to the mistaken conclusion that anti-suit injunctions were merely a subset of interim measures as defined in draft article 17.

77. In favour of dealing with anti-suit injunctions under draft article 17, it was stated that these injunctions were becoming more common and served an important purpose in international trade. It was suggested that the fact that such injunctions were not yet familiar to some legal systems spoke in favour of covering such injunctions in the Model Law, with a view to promoting the modernization and harmonization of legal practices. It was stated that, notwithstanding that, in a

number of countries, the law did not recognize these injunctions, there was evidence that arbitral tribunals sitting in such countries were increasingly considering such injunctions. It was also stated that anti-suit injunctions were designed to protect the arbitral process and that it was legitimate for arbitral tribunals to seek to protect their own process. It was pointed out that the issuance of an anti-suit injunction was not to be understood as preventing a party from making an application to the court of the seat of the arbitration seeking a decision as to whether there was a valid arbitration agreement. It was also pointed out that, to the extent there existed concerns about the overall acceptability of anti-suit injunctions, other provisions of the Model Law might offer adequate safeguards, for example in the nature of grounds for refusal of recognition and enforcement, notably through the reference to the law governing the powers conferred upon the court in draft article 17 bis (2) (b) (i), or the reference to public policy in draft article 17 bis (2) (b) (ii).

78. It was stated that, at previous sessions, the Working Group had expressed a degree of preference for not disallowing anti-suit injunctions in draft article 17. It was suggested that, even if no express words were included in paragraph (2) (b) regarding the power to issue anti-suit injunctions, there would nevertheless be implicit support for the existence of such a power, particularly where the UNCITRAL Arbitration Rules applied. It was said that paragraph (2) (a) of draft article 17 was flexible and open-ended and was probably broad enough to encompass anti-suit injunctions. It was said that that interpretation had been strengthened by the fact that the requirement that the interim measure be connected to the subject matter of the dispute (as contained in the original version of article 17 of the Model Law) had been deleted from draft article 17 at a previous session. It was noted that the requirement that interim measures should be linked to the subject matter of the dispute also appeared in article 26 of the UNCITRAL Arbitration Rules and had been understood in some jurisdictions as limiting the availability of anti-suit injunctions. However, some delegations recalled that the linking of interim measures to the “subject matter of the dispute” had nevertheless permitted the ordering of anti-suit injunctions by arbitral tribunals under the UNCITRAL Arbitration Rules.

79. For the sake of clarity, it was suggested that paragraph (2) should expressly confer a power on arbitral tribunals to issue anti-suit injunctions. A number of proposals were made regarding the manner in which anti-suit injunctions should be expressly covered in draft article 17. One proposal was to insert a provision expressly allowing an arbitral tribunal to issue such an injunction, together with an explanatory note stating that that provision would only apply to the extent that such injunctions were permissible under the procedural laws of the country concerned. However, it was said that a drawback of that proposal was that, for countries that did not adopt the express provision, paragraph (2) could be understood as forbidding the issuance of anti-suit injunctions.

80. Another proposal was to address the issue of anti-suit injunctions by adding to paragraph (2) (b) of draft article 17 words along the lines of “or would seriously aggravate the dispute between the parties”. It was stated that that formulation was recognized in certain jurisdictions and had been used in a number of international arbitrations including arbitrations undertaken pursuant to the UNCITRAL Arbitration Rules.

81. Yet another proposal was that the words “or prejudice the arbitral process itself” could be added to the end of paragraph (2) (b) of article 17. It was stated that that proposal would clarify and put beyond doubt the understanding expressed by a number of delegations that the phrase “take action that would prevent, or refrain from taking action that is likely to cause, current or imminent harm”, in paragraph (2) (b), already covered anti-suit injunctions.

82. The view was expressed that the debate on the question of coverage of anti-suit injunctions had proceeded largely on the basis that such injunctions would prevent a party from bringing an action before a court. However, in some cases, these injunctions had been used to prevent a party from bringing an action before another arbitral tribunal. It was suggested that the draft text should encompass both situations.

83. After discussion, the Working Group agreed to amend subparagraph (2) (b) as follows: “Take action that would prevent, or refrain from taking action that is likely to cause, current or imminent harm, or to prejudice the arbitral process itself”. However, noting that the Working Group had not fully considered the implications of the proposed wording, it was agreed that this proposal should be retained in square brackets for further consideration at a future session.

### **Paragraph (3)**

#### *Subparagraph (a)—“Irreparable harm”*

84. Concerns were expressed about the use of the term “irreparable harm” in subparagraph (a). The Working Group recalled that the term had already been discussed at its thirty-fifth session (A/CN.9/508, para. 56) and thirty-ninth session (A/CN.9/545, para. 29).

85. A suggestion was made that the term “irreparable” was not a well-known concept in all legal systems, was subject to divergent interpretations, and should be deleted. Another suggestion was that the term “irreparable” should be replaced by the term “substantial”. It was stated that a reference to “substantial harm” would more easily lend itself to balancing the degree of harm suffered by the applicant if the interim measure was not granted against the degree of harm suffered by the party opposing the measure if that measure was granted.

86. However, strong support was expressed for the retention of the reference to “irreparable harm”. It was stated that paragraph (3) (a) was intended to apply to a particular type of harm occurring in a situation where, even at a preliminary stage when all the facts of the dispute were not before the tribunal, it could be shown that the requesting party should be protected against harm that could not be remedied by an award of damages. By contrast, a reference to “substantial harm” would suggest that it could be remedied by way of substantial damages. It was pointed out that the notion of “irreparable harm” did not refer in quantitative terms to the magnitude of damages, but in qualitative terms to the very nature of the harm. Various examples of “irreparable harm” were given. In addition to the loss of a priceless or unique work of art already mentioned at the previous session (A/CN.9/545, para. 29), it was explained that “irreparable harm” would occur, for example, in situations such as a business becoming insolvent, essential evidence being lost, an essential business opportunity (such as the conclusion of a large contract) being lost, or harm being caused to the reputation of a business as a result of a trademark infringement.

87. Notwithstanding that the notion of “irreparable harm” was well recognized in some legal systems and constituted an ordinary pre-requisite for ordering an interim measure, it was acknowledged, however, that the notion of irreparable harm might lend itself to various interpretations, namely in countries which were not familiar with this notion. It was proposed to replace the expression “irreparable harm” with a more neutral and descriptive phrase. A number of proposals were suggested as follows: “harm that cannot be adequately compensated or that cannot be compensated by an award of money”; “damage that is difficult to repair”; “harm that cannot be compensated”, “important harm which cannot be compensated by damages”, “inevitable harm”, “unavoidable harm” or “serious harm”.

88. In addition to the concerns expressed above, it was stated that, if the Model Law was to provide that interim measures of protection could be granted only to avoid harm that could not be compensated for in monetary terms, there would be a risk that the provision would be interpreted in a very restrictive manner. As a result, interim measures in arbitration might be more difficult to obtain than similar measures in court proceedings, while parties seeking enforcement of such interim measures would still need to engage in additional proceedings before the competent court. The question was raised as to whether it was the intention of the Working Group to adopt such a restrictive approach as to potentially exclude from the field of interim measures any loss that might be cured by an award of damages. It was also stated that, in current practice, it was not uncommon for an arbitral tribunal to issue an interim measure merely in circumstances where it would be comparatively complicated to compensate the harm with an award of damages.

89. With a view to providing a more flexible criterion, another proposal was made to replace the words “irreparable harm” by the words: “harm not adequately reparable by an award of damages”. It was stated that that proposal addressed the concerns that irreparable harm might present too high a threshold and would more clearly establish the discretion of the arbitral tribunal in deciding upon the issuance of an interim measure. The Working Group found that proposal generally acceptable.

*Subparagraph (a)—interplay with paragraph (2)*

90. Comments were made in relation to the content of paragraph (3), when read in conjunction with paragraph (2). A view was expressed that the reference to “harm” in paragraph (3) might lend itself to confusion with the words “current or imminent harm” in subparagraph (b) of paragraph (2), thus creating the risk that the criteria set forth in paragraph (3) might be read as applying only to those measures granted for the purposes of subparagraph (b) of paragraph (2).

91. More generally, a concern was expressed that the general requirements set forth in paragraph (3) might not adequately apply to all types of interim measures listed under paragraph (2). For example, it was stated that it would not be appropriate to require in all circumstances that a party applying simply for an interim measure to preserve evidence under paragraph (2) (d) should necessarily demonstrate that exceptional harm would be caused if the interim measure was not ordered, or to require that requesting party to otherwise meet the very high threshold established in paragraph (3). The Working Group took note of that concern and agreed that the matter might need to be further considered at a later stage.

**Paragraph (4)**

92. It was recalled that the Working Group had, when discussing paragraph (5) of article 17 bis (see above, paras. 54-60), examined the question whether security should be a condition for the granting of an interim measure. A general view emerged that the granting of security should not be a condition precedent to the granting of an interim measure. It was pointed out that article 17 of the Model Law as well as article 26 (2) of the UNCITRAL Arbitration Rules did not include such a requirement. Various proposals were made to amend paragraph (4) accordingly.

93. One proposal was to adopt wording along the following lines: “The arbitral tribunal may grant an interim measure of protection by having appropriate security furnished by the requesting party and any other party”, or simply by providing that, “appropriate security may be required to be provided by the requesting party and any other party before the arbitral tribunal grants an interim measure”. That proposal was objected to on the ground that requiring security to be provided before an interim measure could be granted was said to be too strict a condition. Another proposal was that the words “as a condition for granting an interim measure of protection” should be deleted from paragraph (4). However, the view was expressed that the mere deletion of those words should be avoided, since those words served a useful role as they provided guidance for practitioners. In addition, it was pointed out that the above proposals gave the impression that the tribunal had an independent authority to grant security at any time of the procedure.

94. To address the concern that the provision of security should not be interpreted as a free-standing provision allowing the tribunal to order security at any time during the procedure, a proposal was made to redraft paragraph (4) as follows: “The arbitral tribunal may require the requesting party and any other party to provide appropriate security at the time the arbitral tribunal grants the interim measure”. Yet another proposal was made along the following lines: “The arbitral tribunal may require the requesting party and/or any other party to provide appropriate security in connection with such interim measure of protection”. It was said that, not only did this proposal address the concern raised, but also ensured that the arbitral tribunal would not be limited to ordering security only at the time that the application was brought. It was pointed out that the term “in connection with” should be interpreted in a narrow manner to ensure that the fate of the interim measure was linked to the provision of security. After discussion, that proposal was found acceptable by the Working Group.

95. As a matter of drafting, it was stated that the use of the word “or” was more appropriate than the word “and” to indicate that the arbitral tribunal could require either the requesting party or any other party to provide appropriate security. The Working Group agreed to that proposal.

96. Regarding the possibility for the arbitral tribunal to require “any party” to provide appropriate security, it was pointed out that it was essential to preserve the possibility of requiring the defendant (i.e. the party against whom the interim measure was directed) to provide such security. It was said that that was in line with the principle of equality of treatment between the parties underlying arbitration proceedings. While, admittedly, the defendant would rarely be required to provide security, examples were given of situations where, to obtain the lifting of an interim measure such as an arrest of ship, the defendant would deposit security.

**Paragraph (5)**

97. A question was raised whether the second sentence of paragraph (5), which referred to the communication by one party to the other of all statements, documents or other information supplied to the arbitral tribunal, should be retained. It was suggested that that obligation duplicated an obligation that already applied under article 24 (3) of the Model Law. It was noted that, to the extent the current text would form part of the Model Law, it was not necessary to duplicate any obligation already contained in the Model Law. However, the view was expressed that the obligation of a party to inform the arbitral tribunal was mentioned in article 17 and not in any other part of the Model Law. Thus, for the sake of clarity, it was appropriate to link the obligation to inform the tribunal to the general obligation to inform the other party.

98. Various proposals were made in respect of that provision. It was suggested that, following the word “promptly”, words along the lines of “with copies to all other parties” should be added and the second sentence of paragraph (5) should be deleted. Another suggestion was that the opening words of the paragraph should be redrafted in the following terms: “The requesting party shall promptly make disclosure of any material change (...)” and that the second sentence of paragraph (5) should be deleted. It was suggested that that approach expressed the obligation in a more neutral way and avoided any inference being drawn that the paragraph excluded an obligation under article 24 (3) of the Model Law. After discussion, the Working Group found the latter proposal to be generally acceptable.

*Sanction for non-compliance*

99. It was remarked that, as drafted, paragraph (5) provided no sanction in case of non-compliance with the obligation to inform. It was suggested that such a sanction could be included in paragraph (6) such that a failure to comply with the obligation to disclose would be a ground for modification, suspension or termination of the interim measure.

100. It was stated that the express inclusion of a sanction under paragraph (6) was not necessary, as in any case the usual sanction for non-compliance with the obligation to disclose was either the suspension or termination of the measure, or the award of damages. It was noted, however, that an award of damages might not be a solution in all cases, particularly where the other party was not capable of paying damages. It was suggested that, to better reflect that reality, the following text could be added to the end of paragraph (5): “and any failure to do so may be a ground for suspension or termination under paragraph (6) of this article”. After discussion, the Working Group agreed that it was not necessary to include a provision regarding sanctions in paragraph (5).

**Paragraph (6)**

101. As a matter of drafting, it was pointed out that, whereas article 17 bis (4) referred to “termination, suspension or amendment of that interim measure”, paragraph (6) referred to “modify, suspend or terminate an interim measure”. It was agreed that the texts should be aligned. Preference was expressed for the word “modify” instead of “amend”.

*“It has granted”*

102. It was recalled that the words “it has granted” were inserted to reflect the decision of the Working Group that the arbitral tribunal could only modify or terminate the interim measure issued by that tribunal (A/CN.9/545, para. 41). On that basis, it was agreed that the words “it has granted” should be retained without square brackets.

103. A question was raised whether an arbitral tribunal should be prohibited from modifying an interim measure issued by a court given that a party to an arbitration agreement could apply for an interim measure to a court before the arbitral tribunal had been established. It was suggested that, in such circumstances, there could be good reasons for allowing the tribunal, once constituted, to modify such measures. Some support was expressed for that view.

104. It was noted that the issue of allowing an arbitral tribunal to review a court-ordered interim measure was a contentious matter and raised sensitive issues regarding the role of courts and balancing the role of private arbitral bodies against that of courts, which had sovereign powers and an appellate regime. The Working Group noted that article 9 of the Model Law appropriately addressed the concurrent jurisdiction of the arbitral tribunal and the courts and unambiguously provided for the right of the parties to request an interim measure of protection from a court, before or during the arbitral proceedings. The Working Group agreed that that issue of possible review of a court-ordered interim measure by an arbitral tribunal should not be dealt with in the Model Law. In that connection, it was pointed out that there existed various techniques to address the issue. For example, parties could, of their own initiative, revert to the court that had issued the measure to seek review of that measure, or the parties could ask the court to include within the interim measure, the right for the arbitral tribunal to modify that measure once it was established. In addition, it was always open to the arbitral tribunal to require the parties to revert to the court with the decision made by the arbitral tribunal.

**Paragraph (6 bis)**

105. The Working Group recalled that, in order to assist deliberations on subparagraph (6 bis), the Secretariat had prepared a note (A/CN.9/WG.II/WP.127) containing information received from States on the liability regimes that applied under their national laws in respect of interim measures of protection. It was observed that, of the legislation contained therein, the national laws did not distinguish between *inter partes* and *ex parte* measures in relation to the liability regimes that applied. It was suggested that, for that reason, the square brackets around that subparagraph should be deleted and the Working Group should consider possible improvements to the text therein.

106. It was suggested that the words providing that liability for costs and damages arose “from the date the measure has been granted and for as long as it is in effect” was unnecessary because the requirement that costs and damages be ‘caused by’ the measure already limited their scope”. It was also suggested that the present conditions set out in paragraph (6 bis) might be confusing and the requirement that made liability dependent on the final disposition of the claims on the merits might be inappropriate. In this respect, the Working Group was reminded that, at its thirty-ninth session, it was strongly felt that the final decision on the merits should not be

an essential element in determining whether the interim measure was justified or not (A/CN.9/545, para. 68). For these reasons, a first proposal was made to replace the first sentence of paragraph (6 bis) by the words “The requesting party shall be liable for any costs and damages caused by the interim measure of protection to the party against whom it is directed, if the arbitral tribunal later determines that, in the circumstances, the interim measure should not have been granted.” Support was expressed for that proposal.

107. A concern was expressed that paragraph (6 bis) appeared to provide that the power of the tribunal to order damages was triggered if the tribunal found that the interim measure should not have been ordered, which might not provide a broad enough discretion, for example, to allow an arbitral tribunal to exercise that power where it found that the measure had been made on incorrect facts. To achieve that broader discretion, a second alternative proposal was made to replace the entire text of paragraph (6 bis) by the following: “The requesting party shall be liable for such costs and damages that is caused by the interim measure of protection to the party against whom it is directed, as may be awarded by the arbitral tribunal, at such time in the course of the proceedings and to such extent as it considers appropriate having regard to all the relevant circumstances.” It was stated that, if that formulation were accepted, the second sentence of paragraph (6 bis) could be deleted. That proposal received little support. Preference was expressed for the first proposal, which was said to address the concerns expressed and to provide more guidance than the second proposal.

108. With respect to the last sentence of paragraph (6 bis) it was suggested that the term “immediate” should be deleted as it could be misinterpreted as suggesting that the damages would be awarded simultaneously with the interim measure. It was suggested that the sentence be replaced by the following words: “The arbitral tribunal may order an award of costs and damages at any point during the proceedings following the termination of the interim measure.” It was suggested that the words “following the termination of the interim measure” were unduly narrow given that they restricted the award of damages to the time after the termination of the interim measure. It was agreed that the words “following the termination of the interim measure” should be deleted. It was also agreed that any explanatory material accompanying paragraph (6 bis) should clarify that the reference to “proceedings” therein referred to the arbitral proceedings and not to the proceedings relating to the interim measure. Subject to these modifications, the proposed text was adopted in substance by the Working Group.

### **Paragraph (7)**

#### *Ex parte measures*

109. The Working Group recalled that, at previous sessions, the question whether to include a provision allowing for interim measures to be ordered *ex parte* by an arbitral tribunal had been extensively discussed and that opposing views had been expressed as to whether this matter should be included in draft article 17. The Working Group also recalled that the Commission, at its thirty-sixth session, noted the suggestion that the issue of *ex parte* interim measures, which the Commission agreed remained a point of controversy, should not delay progress on the finalization of draft article 17 (A/58/17, para. 203).



110. At its thirty-ninth session, the Working Group proceeded with a detailed review of paragraph (7), and agreed that discussions as to whether, as a matter of general policy, a provision on interim measures granted *ex parte* should be retained in draft article 17, should be held at its next session (A/CN.9/545, para. 50). It was also pointed out that *ex parte* interim measures were not dealt with extensively in national laws, general principles of law and international commercial practice. It was pointed out that it might be counter-productive for an UNCITRAL instrument to attempt to regulate an issue for which little recognition existed.

111. Comments made during the current session indicated that there remained strongly opposing opinions on the question of including a provision granting the arbitral tribunal the power to grant *ex parte* measures. On the one hand, it was said that there was no worldwide consensus with respect to the standards and practices concerning the granting of *ex parte* interim measures by arbitral tribunals and that inclusion of such a provision in the absence of such consensus could undermine the role of the Model Law as an international standard reflecting worldwide consensus.

112. On the other hand, it was said that the role of UNCITRAL went beyond merely harmonizing existing laws and that it had regularly taken the lead in developing new and modern rules, looking at their potential economic impact and evaluating the best practice. It was stated that the Working Group had an opportunity to address the emerging reality that *ex parte* orders were being requested and a failure to include such rules would not diminish their importance. The view was expressed that, while the need to regulate *ex parte* measures might be questioned, attention should be given to avoid introducing into the Model Law provisions that could inhibit the possible future development of practice relying on such measures. Support was expressed for the idea that, notwithstanding the absence of consensus, the Working Group could take account of the existing body of opinion in favour of *ex parte* measures and produce a text for use by those jurisdictions that wished to adopt legislation on that matter. It was also pointed out that a number of international arbitral institutions had adopted emergency rules for arbitrators to accommodate the increasing demand for such orders, for example, in the field of sport arbitration.

113. The view was expressed that the current draft of paragraph (7), which had strengthened and increased the safeguards against misuse of *ex parte* measures, might be acceptable to the Working Group.

114. A number of alternative proposals were made to the present draft paragraph (7). One proposal, as contained and explained in the proposal by the International Chamber of Commerce (A/CN.9/WG.II/WP.129), read as follows:

“(a) Unless otherwise agreed by the parties, the arbitral tribunal grant an interim measure of protection, without giving the party [against whom the measure is directed] [affected by the measure] an opportunity [to oppose the measure] [to be heard], when:

“(i) There is an urgent need for the measure;

“(ii) The circumstances set out in paragraph (3) are met; and

“(iii) The requesting party shows that it is necessary to proceed in that manner in order to ensure that the purpose of the measure is not frustrated before it is granted;

“(b) The requesting party shall:

“(i) Be liable for any costs and damages caused by the measure to the party [against whom it is directed] [affected by the measure] [to the extent appropriate, taking into account all of the circumstances of the case, in light of the final disposition of the claims on the merits]; and

“(ii) Provide security in such form as the arbitral tribunal considers appropriate [, for any costs and damages referred to under subparagraph (i).] [as a condition to granting a measure under this paragraph];

“(iii) Give notice of the application for the measure to the party [against whom it is directed] [affected by the measure] at the time such application is made;

“(c) [For the avoidance of doubt,] the arbitral tribunal shall have jurisdiction, *inter alia*, to determine all issues arising out of or relating to [subparagraph (b)], above;]

“(d) [The party [against whom the interim measure of protection is directed] [affected by the measure granted] under this paragraph shall be given an opportunity to [oppose the measure and to] be heard by the arbitral tribunal [within forty-eight hours of the notice, or on such other date and time as is appropriate in the circumstances];]

“(e) [Any interim measure of protection ordered under this paragraph shall be effective for no more than twenty days [from the date on which the arbitral tribunal orders the measure] [from the date on which the measure takes effect against the other party], which period cannot be extended. This subparagraph shall not affect the authority of the arbitral tribunal to grant, confirm, extend, or modify an interim measure of protection under paragraph (1) after the party [against whom the measure is directed] [affected by the measure] has been given an opportunity [to oppose the measure] [and be heard];]

“(f) [A party requesting an interim measure of protection under this paragraph shall have an obligation to inform the arbitral tribunal of all circumstances that the arbitral tribunal is likely to find relevant and material to its determination whether the requirements of this paragraph have been met;]

*Suggested changes to article 17 bis, paragraphs 1 and 6*

“(1) An interim measure of protection issued by an arbitral tribunal, that satisfies the requirements of article 17 shall, with the exception of an interim measure of protection issued under article 17 (7), be recognized as binding and, unless otherwise provided by the arbitral tribunal, enforced upon application [in writing] to the competent court, irrespective of the country in which it was issued, subject to the provisions of this article.

“Paragraph (6) of article 17 bis should be deleted in its entirety.”

115. An additional proposal for the replacement of paragraph (7) read as follows:

“In cases where the prior disclosure of the requested measure to the party having to perform it risks prejudicing its implementation, the requesting party

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may file its application without communicating it to any other party. Upon receipt of such an application, the arbitral tribunal shall communicate it to the other parties inviting their response. The arbitral tribunal may accompany this communication with a provisional [order preventing the frustration of the requested measures]/[for preserving the status quo] until it has heard the other parties and has ruled on the application [provided that such provisional order shall remain in force no longer than X days].”

116. Due to the absence of sufficient time, the Working Group did not discuss those proposals in detail. The Working Group took note of the proposals and decided that the discussion would be continued at its next session on the basis of the documentation prepared for the current session and of the additional proposal, as well as any further proposal that might be communicated to the Secretariat for the preparation of the next session of the Working Group. It was pointed out that, in addition to discussing the contents of a provision on *ex parte* measures, the Working Group would need to focus its attention on the placement of such a provision. Suggestions for the placement included a footnote to article 17, either in the form of an opt-in or opt-out provision, for consideration by national legislators.

**D. Note by the Secretariat on the settlement of commercial disputes:  
interim measures of protection–liability regime, working paper submitted  
to the Working Group on Arbitration at its fortieth session  
(A/CN.9/WG.II/WP.127) [Original: English/French/Spanish]**

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## **Introduction**

1. At its thirty-seventh session (Vienna, 7-11 October 2002), the Working Group had agreed that the revised draft of article 17 of the Model Law on International Commercial Arbitration relating to interim measures of protection ordered by an arbitral tribunal should ensure that the requirement that the party seeking the measure give security be mandatory and that the requesting party be considered strictly liable for damages caused to the responding party by an unjustified measure (A/CN.9/523, para. 31).

2. At the thirty-ninth session of the Working Group (Vienna, 10-14 November 2003), various questions were raised concerning such liability provision:

- One question was whether a general liability provision should apply not only to interim measures ordered on an *ex parte* basis but also to those ordered on

an *inter partes* basis. In support of establishing such a general liability provision, it was stated that in either case, the measure could ultimately be found to have been unjustified to the detriment of the responding party. However, some opposition was expressed to the suggestion that a liability regime should apply generally to both *ex parte* and *inter partes* measures. It was said that the strict liability imposed in the context of *ex parte* measures was appropriate given the nature of such measures, due to the risks inherent in such procedure. However, it was said that misrepresentation or fault in relation to the *inter partes* regime could be dealt with by procedural national laws. As a general remark, it was said that the provision should be limited to establishing the basic principles of a liability regime, without dealing in any detail with substantive issues covered by national laws (A/CN.9/545, para. 60).

- The definition of the scope of the damages intended to be covered was questioned. Diverging views were expressed as to whether a wider definition of damages (which would provide appropriate safeguards) or a more limited one (restricting the ambit of the rule to direct damages) should be retained (A/CN.9/545, para. 64).
- Another question was whether merely requesting an *ex parte* interim measure should make the requesting party liable for damages caused, irrespective of whether the measure was found to be justified or unjustified and irrespective of whether there was any fault by the requesting party. The prevailing view, however, was that the requesting party should be liable only if the measure was ultimately found to have been unjustified. Questions were raised as to the meaning to be attributed to the word “unjustified” and whether the notion of an “unjustified” measure should be considered per se, or in the light of the results on the merits. It was strongly felt, in that respect, that the final decision on the merits should not be an essential element in determining whether the interim measure was justified or not (A/CN.9/545, para. 65).

3. In preparation for the continuation of its deliberations on this topic, the Working Group agreed that the matter could profit from additional information regarding the liability regimes in the context of national laws on interim measures of protection and all delegations were invited to make such information available to the Secretariat in preparation for the fortieth session of the Working Group (A/CN.9/545, para. 61).

4. Part I of this note reproduces the information received from States on that matter in the form in which such information was communicated. Part II provides a summary of texts being drafted by other international organizations in respect of this issue. Earlier drafts of these texts are reproduced in A/CN.9/WG.II/WP.108, para. 108 and A/CN.9/WG.II/WP.119, paras. 68-71.

## **I. National legislation communicated to the Secretariat by delegations**

### **A. Austria**

[Original: English]

5. According to the present legislation on arbitration (articles 577-599 of the Austrian Code of Civil Procedure), an arbitral tribunal is not empowered to issue an

interim measure of protection and only courts can issue interim measures. The court has to decide whether to grant the measure upon application by the requesting party, on the basis of immediately available evidence provided simultaneously by the requesting party to support the claim. The decision to hear the party against whom the measure is directed lies within the discretion of the court. In any case, the court has to make sure that the hearing does not jeopardize the success of the interim measure.

6. Interim measures which are granted before the claim becomes due or before judicial proceedings are initiated, must be justified in the main judicial proceedings. When granting the interim measure, the court will set a time-limit for the requesting party to initiate judicial proceedings. Should the requesting party fail to initiate proceedings within this time-limit, the court *ex officio* will set aside the interim measure.

7. The liability regime under Austrian law applies generally to both *ex parte* and *inter partes* measures. According to article 394 of the Code of Execution, the requesting party is liable for all pecuniary damages caused by the measure to the party against whom it is directed, if the claim, for which the interim measure has been granted, proves to be unfounded in the subsequent main proceedings or if the requesting party fails to institute legal proceedings within due time. The Austrian provision imposes strict liability. The requesting party is liable to compensate all pecuniary damages caused by the interim measure. The pecuniary damages cover all pecuniary losses, prevented gains and the necessary costs of the party against whom the interim measure is directed to defend its case. Legal costs for representation of the party against whom the interim measure is directed must also be compensated.

## B. Canada (Province of Quebec)

[Original: English/French]

8. Article 755 of the Code of Civil Procedure provides that:

“Unless, for good reason, the court or the judge granting an interlocutory injunction decides otherwise, the applicant must be ordered to give security, in a prescribed amount, to pay the costs and damages which may result therefrom. The certificate of the clerk that the security has been given must be attached to the order before it is served.

A judge may at any time increase or reduce the amount of such security [1965 (1st sess.), c. 80, s. 755; 1992, c. 57, s. 420].”

## C. Czech Republic

[Original: English]

9. The power to grant interim measure is exclusively allocated to courts. The courts have the same power to provide interim measure of protection to arbitration parties, as they have for parties to court proceedings.

10. Section 22 of Act No. 216/1994, Statute Books of the Parliament of the Czech Republic, on Arbitral Proceedings and Enforcement of Arbitral Awards (approved on

1.11.1994, entered into force as of 1.1.1995) provides that “If pending the proceedings, or before their commencement, circumstances emerge, likely to jeopardise the execution of the arbitral award, a Court of Law, acting on application of any of the parties, may order a preliminary measure (injunction).” According to this provision, which is mandatory, arbitral tribunals are not allowed to issue any interim measure at any time.

11. The legislation in the Czech Republic does not provide for cross-border enforcement of arbitrator-granted interim relief. Under the Czech law, any arbitrator-granted interim relief cannot be enforced in the Czech Republic.

#### D. Finland

[Original: English]

12. Chapter 7, section 11, of the Finnish Code of Judicial Proceedings provides that, if an interim measure of protection is later found unjustified, the party who has requested the measure shall pay compensation to the other party for any damage that the measure or its enforcement has caused the latter as well as compensation for those costs that he paid in order to cancel the measure (e.g. costs for providing a security). This provision means that the party upon whose request the measure has been granted and possibly enforced has a strict liability (*sine culpa*) for any damage—both direct and indirect—the measure or its enforcement has caused the other party.

#### E. France

[Original: French/English]

13. Below is an extract of the New Code of Civil Procedure on interim measures of protection granted by courts, as translated under the official legal web site of the French Government (“*legifrance. gov. fr*”).

“*Article 489* (Decree No. 81-500 of 12 May 1981, sec.18, Official Journal of 14 May 1981 amendment JORF 21, May 1981): The summary interlocutory procedure orders shall be provisionally enforceable. The judge may notwithstanding the above, subject its provisional enforcement to the providing of an undertaking in the manner as specified under Articles 517 to 522.

Should the occasion arise, the judge may order the enforcement to be executed upon the mere production of the original.

*Article 517*: Provisional enforcement may be made subject to the providing of undertakings relating to real or personal property sufficient to cover restitutions and damages.

*Article 518*: The nature, extent and conditions of the undertakings shall be specified in the decision which prescribes that they be provided.

*Article 519* (Decree No. 76-714 of 29 July 1976, sec. 2, Official Journal of 30 July 1976): Where the undertakings shall consist in a sum of money, the same shall be deposited at the Deposits and Consignation Office; it may be

deposited also at the request of one of the parties in the hands of a third party appointed for that purpose.

In the latter case, the judge, where he accedes to the request, shall state in his decision the conditions of such deposit.

Where the third party refuses to accept such a deposit, the sum shall be deposited, without any fresh decision to that effect, at the Deposits and Consignation Office.

*Article 520:* Where the value of the security may not be immediately determined, the judge shall invite the parties to appear before him with their evidence at a date which he shall specify.

It shall be determined without any right of review.

A note of the decision shall be made on the original and on the certified copies of the judgment.

*Article 521* (Decree No. 81-500 of 12 May 1981, sec.21, Official Journal of 14 May 1981 amendment JORF of 21 May 1981), (Decree No. 84-618 of 13 July 1984, sec.3 and 31, Official Journal of 18 July 1984 amendment JORF of 18 August 1984): The party ordered to pay a sum other than in view of maintenance, compensatory annuities or interim payment may avoid provisional execution by depositing, on leave granted to that effect by the judge, cash or title of sufficient value to provide a security for the amount of the award with respect to the principal claim, interest and costs.

In the event of a judgment ordering the payment of a lump sum as indemnity in cases of personal injury, the judge may also order that it be remitted to a sequester under the condition that he shall pay to the victim such installments as the judge shall specify.

*Article 522:* The judge may, at any time, authorise the substitution of the original security for one of an equal value.”

14. The principle adopted by the courts when granting interim measures of protection is as follows:

“Provisional execution of interim measures of protection is effected at the risk of the petitioner and, where the ruling is set aside, he shall be responsible for reparation of any damage caused by such execution.”

## F. Germany

[Original: English]

15. Section 1041, sub. 4 of the Arbitration Law provides that:

“If a measure ordered under subsection 1 (interim measure ordered by an arbitral tribunal) proves to have been unjustified from the outset, the party who obtained its enforcement is obliged to compensate the other party for damage resulting from the enforcement of such measure or from his providing security in order to avoid enforcement. This claim may be put forward in the pending arbitral proceedings.”



16. This provision reflects the statutory provisions under German law for interim measures granted unjustly by state courts and is an expression of a general principle of law. Thus it was included in the Arbitration Act—according to general consensus—for the sake of clarification and to reiterate the idea that a party seeking interim measures of protection without sufficient cause must compensate damages arising therefrom *ipso jure*, i.e. without an express undertaking to do so.

17. Apart from this provision, there is no further specific statutory provision dealing with the consequences of unjustified interim measures.

## G. Singapore

[Original: English]

18. The International Arbitration Act, 1995, which enacts the UNCITRAL Model Law on International Commercial Arbitration with modifications, provides, in its section 12, that an arbitral tribunal has the power to make orders, or give directions to any party, for:

- Security for costs
- Preservation, interim custody or sale of any property which is the subject matter of the dispute
- Securing the amount in dispute
- Preventing dissipation of assets by a party
- An interim injunction or any other interim measure.

19. Orders and directions given by an arbitral tribunal are by leave of the High Court enforceable in the same manner as orders made by a court. The High Court has power to make similar orders for the purpose of, and in relation to, an arbitration as it has for the purpose of, or in relation to, an action or matter in court. These matters are provided for in section 12 of the International Arbitration Act.

20. With respect to liability for damages arising from interim orders, in the absence of jurisprudence to the contrary, it is assumed that the practice in relation to interim orders made in arbitration proceedings would follow the practice in relation to interim orders issued by courts in relation to cases before courts.

21. A central feature in court practice is that the applicant is almost always required to undertake to abide by any order the court may make as to damages in the event the order is shown subsequently to have been unjustly made. In fact, the plaintiff when applying for an order always offers the undertaking. On the application of the party to be affected, the court may require the applicant to back up his undertaking with security, such as in the form of a bank guarantee.

22. The court may order damages to be paid if, for example, at the end of the trial, the plaintiff fails to establish his claim. This would be the case, for instance, if the plaintiff had obtained an order securing the amount in dispute but at the end of the trial loses the case altogether. In such an instance, the view may be taken that the interim order had been wrongly applied for, and the defendant should be compensated for the consequence of such a wrongly issued order.

23. An undertaking in respect of damages is required for interim orders obtained *ex parte* as well as those obtained *inter partes*. In the case of an *ex parte* order, the plaintiff is required to make full and frank disclosures of factors which might mitigate against the granting of the order. If the plaintiff is later shown to have withheld material facts from the court when applying for the order *ex parte*, the *ex parte* order may be discharged for that reason alone whatever other merits it might have. In such a situation, too, the applicant will have to make good his undertaking to pay damages.

24. Singapore's court practice in relation to interim orders of protection follows that of England and other common law countries.

## H. Spain

[Original: Spanish]

25. The Civil Procedure Act (Act 1/2000, 7 January) expressly provides that any person who is party to arbitral proceedings abroad may appeal for interim measures of protection from a Spanish court. Under article 733 of the Act, the party may request interim measures of protection *inaudita parte (ex parte)* in cases of urgency or where the hearing may result in successful referral to arbitration of the interim measure. Security must be provided in the case of both *inter partes* and *ex parte* interim measures. Once an interim measure is adopted and security provided, execution ensues automatically.

26. *Inter partes* interim measures: Under article 745 of the Act, in the event of acquittal, or if the case is withdrawn or discontinued, "all the interim measures adopted shall be withdrawn automatically" and, on application by the defendant, any "damages that the defendant may have suffered" shall be determined.<sup>1</sup>

27. *Inaudita parte (ex parte)* interim measures: Under article 739 of the Act, the court is obliged to inform the other party of the court order in which the measure was adopted, in order to enable him to lodge objections. The deadline for objections is 20 days following notification of the court order. The other party is provided with a copy of the document in order that it may also formulate its submission.

Under article 741 of the Act, the court may, following the hearing:

(a) Maintain the interim measure. In such case, "the costs of objection shall be borne by the objecting party";

(b) Withdraw the interim measure. In such case, "the costs and damages resulting from the interim measure shall be borne by the petitioner".<sup>2</sup>

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<sup>1</sup> Article 745. *Withdrawal of measures upon acquittal*

In the event of discharge or acquittal, all interim measures adopted shall automatically be withdrawn and the provisions of article 742 concerning the damages that the defendant may have suffered shall be implemented. The same procedure shall be adopted in the event of withdrawal or abandonment of the case.

<sup>2</sup> Article 741. *Transmission of objections to the petitioner, hearing and decision*

1. Objections shall be transmitted to the petitioner and the provisions of article 734 shall be implemented immediately.

2. The court shall, within five days after the hearing, issue a written decision on the objections. If the interim measures are withdrawn, the petitioner shall be liable for the costs and any damages.

## I. Switzerland

[Original: French]

28. Article 364 of the New Act on Civil Procedure, on provisional measures, security and damages, provides that:

- “1. Unless the parties agree otherwise, the arbitral tribunal or the court may, on application by a party, order interim measures, for the purpose, among others, of preserving evidence.
2. Where the person targeted by the measures does not submit to them voluntarily, the arbitral tribunal or a party, by agreement with the tribunal, may apply to the court for the necessary order. The court shall apply its own law.
3. The arbitral tribunal or the court may make the required interim measures conditional on the provision of appropriate security, where such measures may cause damage to the other party.
4. The petitioner is responsible for damage caused to the other party by unjustified interim measures. If he can prove that the petition was made in good faith, the tribunal may reduce or refuse to award damages. Claims may be raised during arbitral proceedings that are pending.
5. Security shall be released once it is established that no action for damages will be brought; in case of uncertainty, the arbitral tribunal shall grant the interested party further time to take action.”

## J. United States of America

[Original: English]

29. With few exceptions, federal and state courts in the United States hold a party liable for damages suffered by another party due to a wrongfully issued interim measure of protection. Federal and state law generally require that a party requesting a preliminary injunction or temporary restraining order provide a security bond, which is then available to indemnify the affected party for all costs and pecuniary injury resulting if the measure turns out to have been wrongfully granted.

30. Rule 65 of the Federal Rules of Civil Procedure establishes the general procedures for preliminary injunctions, permanent injunctions and temporary restraining orders under federal law, including provisions to guard against abuse of the injunction remedy. Specifically, 65(c) provides that parties requesting the imposition of a provisional remedy tender a security bond to the court:

“No restraining order or preliminary injunction shall be issued except upon the giving of security by the applicant, in such sum as the court deems proper, for the payment of such costs and damages as may be incurred or suffered by any party who is found to have been wrongfully enjoined or restrained.”

31. The requirement of a security bond is strictly enforced. Courts agree that the purpose of the security bond is to guarantee the payment of costs and damages a party incurs, where it is subsequently found the party was wrongfully enjoined or

restrained. In *Blumenthal v Merrill Lynch*, 910 F.2d 1049, 1055-1056 (2d Cir.1990) the United States Court of Appeals for the Second Circuit held that former employees, vindicated on a central issue in an arbitration dispute, were entitled to damages for losses proximately caused by the imposition of a preliminary injunction. The Seventh, Ninth, and Eleventh Circuits have all come to the same conclusion under similar circumstances.

32. A party has been wrongfully enjoined or restrained within the meaning of Rule 65(c) when he had the right to do what he was enjoined from doing. *Nintendo of America v. Lewis Galoob Toys, Inc.*, 16 F.3d 1032, 1036. *See also, Blumenthal*, 910 F.2d at 1054 (“The focus of the ‘wrongfulness’ inquiry is whether, in hindsight in light of the ultimate decision on the merits after a full hearing, the injunction should not have been issued in the first instance.”). In some circumstances, even a party that has not entirely won on the merits and has been ordered to pay some damages may nonetheless also be awarded damages for a wrongfully issued interim order (*Id.* at 1056).

33. Rule 65(c) mandates the issuance of security bonds, and a district court may dispense with this requirement only in very limited circumstances. Failure even to consider the issue of a security bond has been found to be reversible error. The 3d Circuit in *Hoxworth v Blinder, Robinson & Co*, 903 F.2d 186,209-211 (3d Cir.1990), for example, held that a court’s failure to require plaintiffs in a civil-RICO action to post a bond constituted reversible error. The 4th Circuit, in *District 17, U.M.W.A V. A & M Trucking*, 991 F.2d 108, 110 (4th Cir.1993) and the 5th Circuit in *Philips v Chas. Schreiner Bank*, 894 F.2d 127, 131 (5th Cir.1990) also came to the same conclusion.

34. Where a party lacks the resources to pay a bond and a bond requirement may discourage that party from enforcing important federal laws and rights (such as in employment discrimination claims), or might affect the party’s ability to exercise the right to judicial review, a court may dispense with the bond requirement. *Crowley v Local No. 82*, 679 F.2d 978,1000 (1st Cir. 1982). Where litigation is in the public interest and the movant lacks the resources to provide the bond, *Pharmaceutical Society v New York Dep’t of Soc. Servs.*, 50 F.3d 1168, 1174-1175 (2d. Cir. 1995), a court may also dispense with the requirement. Where there is no risk of monetary losses to the defendant, or where the movant possesses the financial resources to pay whatever damages, *Continental Oil Co. v Frontier Ref. Co.*, 338 F.2d 780, 782-783 (10th Cir. 1964), courts have also dispensed with the security bond requirement.

35. The amount of the security bond is left to the court’s discretion. (*Alexandria v Primerica Holdings Inc*, 811 F.Supp. 1025, 1038 (D.N.J. 1993), *See also, Gateway E. Ry. v. Terminal R.R. Ass’n*, 35 F.3d 1134, 1141-1142 (7th Cir. 1994)).

## II. Work of international organizations

### A. International Law Association Principles

[Original: English]

36. At its sixty-seventh Conference in 1996, the International Law Association (ILA) adopted the “Principles of Provisional and Protective Measures in

International Litigation”<sup>3</sup> (the “ILA Principles”), which were drafted with the international litigation process in mind, as opposed to interim measures granted by a court in support of an international arbitration (the Principles were reproduced verbatim in paragraph 108 of A/CN.9/WG.II/WP.108). The provision relating to liability and its related commentary provides as follows:

*Provision:*

“The court should have authority to require security or other conditions from the plaintiff for the injury to the defendant or to third parties which may result from the granting of the order. In determining whether to order security, the Court should consider the availability of the plaintiff to respond to a claim for damages for such injury.”

*Comments:*

As a safeguard for the respondent, the court may need to have the authority to require security or other conditions (such as an undertaking by the applicant to indemnify the respondent if the measure proves to be unjustified) from the applicant for the potential injury to the respondent or to third parties which may result from the granting of the order, such as where the order is unjustified or too broad. If an undertaking as to damages might prove insufficient and the court considers ordering security, an additional consideration might relate to the ability of the applicant to respond to a claim for damages for such injury (A/CN.9/WG.II/WP.119, para. 58).

## **B. American Law Institute/Unidroit: Draft Principles and Rules of Transnational Civil Procedure**

[Original: English]

37. The Draft Principles and Rules of Transnational Civil Procedure is a joint project to set up procedural rules that a country could adopt for adjudication of disputes arising from international transactions. The April 2003 revision of the draft Principles contains the following principles and comments relating to indemnification.

*Provision:*

“8.3 An applicant for provisional relief should be liable for full indemnification of a person against whom the relief is issued if, upon subsequent reconsideration with participation of other parties, the court determines that the relief should not have been granted. The court may require the applicant for provisional relief to post a bond or formally to assume a duty of indemnification.”

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<sup>3</sup> The International Law Association (ILA), Report of the sixty-seventh Conference held at Helsinki from 12-17 August 1996—Committee on International Civil and Commercial Litigation, Second interim report on provisional and protective measures in international litigation, published by the ILA, London 1996.

*Comments:*

“*P-8F* Principle 8.3 authorizes the court to require a bond or other indemnification, as protection against the disturbance and injury that may result from an injunction. The particulars of such indemnification should be determined by the law of the forum. An obligation to indemnify should be express, not merely by implication, and could be formalized through a bond underwritten by a third party.”

**E. Note by the Secretariat on the settlement of commercial disputes:  
interim measures of protection, working paper submitted to  
the Working Group on Arbitration at its fortieth session  
(A/CN.9/WG.II/WP.128) [Original: English]**

## **Introduction**

1. At its thirty-sixth session (New York, 4-8 March 2002) and at its thirty-seventh session (Vienna, 7-11 October 2002), the Working Group discussed a draft of article 17 of the UNCITRAL Model Law on International Commercial Arbitration (“the UNCITRAL Model Law”) relating to the power of an arbitral tribunal to order interim measures of protection (A/CN.9/523, paras. 15-76; A/CN.9/508, paras. 51-94; for earlier discussions, see A/CN.9/468, paras. 60-87; A/CN.9/485, paras. 78-106; A/CN.9/487, paras. 64-87) and considered various proposals for a revision of that article (A/CN.9/WG.II/WP.119, para. 74; A/CN.9/WG.II/WP.121).
2. At its thirty-ninth session (Vienna, 10-14 November 2003), the Working Group continued its deliberations on draft article 17 of the UNCITRAL Model Law (“the previous draft”), on the basis of a note prepared by the Secretariat (A/CN.9/WG.II/WP.123). The report of that session is contained in document A/CN.9/545.
3. To facilitate the resumption of discussions, this note sets out a newly revised version of article 17 of the UNCITRAL Model Law (“the revised draft”), taking account of discussions and decisions made at the thirty-ninth session of the Working Group.

### **Newly revised draft of article 17 of the UNCITRAL Model Law on International Commercial Arbitration regarding the power of an arbitral tribunal to grant interim measures of protection**

- (1) Unless otherwise agreed by the parties, the arbitral tribunal may, at the request of a party, grant interim measures of protection.
- (2) An interim measure of protection is any temporary measure, whether in the form of an award or in another form, by which, at any time prior to the issuance of the award by which the dispute is finally decided, the arbitral tribunal orders a party to:
  - (a) Maintain or restore the status quo pending determination of the dispute;
  - (b) Take action that would prevent, or refrain from taking action that is likely to cause, current or imminent harm;
  - (c) Provide a [preliminary] means of [securing] [preserving] assets out of which a subsequent award may be satisfied; or
  - (d) Preserve evidence that may be relevant and material to the resolution of the dispute.

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- (3) The party requesting the interim measure of protection shall satisfy the arbitral tribunal that:
- (a) [Irreparable harm] is likely to result if the measure is not ordered, and such harm substantially outweighs the harm that is likely to result to the party against whom the measure is directed if the measure is granted; and
  - (b) There is a reasonable possibility that the requesting party will succeed on the merits, provided that any determination on this possibility shall not affect the discretion of the arbitral tribunal in making any subsequent determination.
- (4) The arbitral tribunal may require the requesting party and any other party to provide appropriate security as a condition to granting an interim measure of protection.
- (5) The requesting party shall inform the arbitral tribunal promptly of any material change in the circumstances on the basis of which the party made the request for, or the arbitral tribunal granted, the interim measure of protection. All statements, documents or other information supplied to the arbitral tribunal by one party shall be communicated to the other party.
- (6) The arbitral tribunal may modify, suspend or terminate an interim measure of protection [it has granted], at any time, upon application of any party or, in exceptional circumstances, on the tribunal's own initiative, upon prior notice to the parties.
- [(6 bis) The requesting party shall be liable for any costs and damages caused by the interim measure of protection to the party against whom it is directed from the date the measure has been granted and for as long as it is in effect [to the extent appropriate, taking into account all of the circumstances of the case, in light of the final disposition of the claims on the merits]. The arbitral tribunal may order an immediate award of damages.]
- (7) (a) [Unless otherwise agreed by the parties] [If expressly agreed by the parties], the arbitral tribunal may [in exceptional circumstances,] grant an interim measure of protection, without notice to the party against whom the measure is directed, [when] [if the requesting party shows that]:
- (i) There is an urgent need for the measure;
  - (ii) [The conditions set out in paragraph (3) are met]; and
  - (iii) The requesting party [shows] [satisfies the arbitral tribunal] that it is necessary to proceed in that manner in order to ensure that the purpose of the measure is not frustrated before it is granted;
- (b) The requesting party shall be liable for any costs and damages caused by the interim measure of protection to the party against whom it is directed from the date the measure has been granted and for as long as it is in effect [to the extent appropriate, taking into account all of the circumstances of the case, in light of the final disposition of the claims on the merits]. The arbitral tribunal may order an immediate award of damages;



- (c) The arbitral tribunal shall require the requesting party and any other party to provide appropriate security as a condition to granting an interim measure of protection;
- (d) *Variant 1:* The arbitral tribunal shall have jurisdiction, inter alia, to determine all issues arising out of or relating to subparagraph (b) [and (c)] above, [at any time during the arbitration proceedings];
- Variant 2:* A party may, at any time during the arbitration proceedings, bring a claim under subparagraph (b);
- (e) *Variant A:* The party against whom the interim measure of protection is directed shall be given immediate notice of the measure and an opportunity to present its case before the arbitral tribunal at the earliest possible time and in any event no later than [forty-eight] hours after that notice, or on such other date and time as is appropriate in the circumstances;
- Variant B:* Any party affected by the interim measure of protection granted under this paragraph shall be given immediate notice of the measure and an opportunity to present its case before the arbitral tribunal within [forty-eight] hours of the notice, or on such other date and time as is appropriate in the circumstances.
- (f) Any interim measure of protection ordered under this paragraph shall expire after twenty days from the date on which the arbitral tribunal orders the measure, unless that measure has been confirmed, extended or modified by the arbitral tribunal [, upon application by the requesting party and] after the party against whom the measure is directed has been given notice and an opportunity to present its case. All statements, documents or other information supplied to the arbitral tribunal by one party shall be communicated to the other party;
- (g) A party requesting an interim measure of protection under this paragraph shall [inform the arbitral tribunal of] [place before the arbitral tribunal information relating to] all circumstances that the arbitral tribunal is likely to find relevant and material to its determination [whether the requirements of this paragraph have been met] [whether the arbitral tribunal should grant the measure].

## Notes on the revised draft

### Paragraph (1)

4. The Working Group adopted paragraph (1) without modification (A/CN.9/545, para. 20).

### Paragraph (2)

#### *Exhaustive nature of the list of provisional measures*

5. The Working Group agreed that, to the extent that the revised list of circumstances in paragraph (2) generically covered all the purposes for which interim measures could be ordered, it was not necessary to make the list non-

exhaustive by providing a subparagraph to leave open the possibility that an arbitral tribunal might order an interim measure in exceptional circumstances (A/CN.9/545, para. 21).

*Chapeau*

6. The chapeau of paragraph (2) is reproduced without modification from the previous draft.

*Subparagraphs (a) and (b)—“[in order to ensure or facilitate the effectiveness of a subsequent award]”*

7. The Working Group decided to delete the bracketed text “[in order to ensure or facilitate the effectiveness of a subsequent award]” because it could be misinterpreted as imposing an additional condition to be met before an interim measure could be granted (A/CN.9/545, para. 22).

*Subparagraph (a)—“maintain or restore the status quo”*

8. It was agreed to retain subparagraph (a), which set out the concept of maintaining the status quo, since that concept was well established and understood in many legal systems as one purpose of an interim measure (A/CN.9/545, para. 23).

*Subparagraph (b)—“is likely to cause”*

9. The words “is likely to cause” have replaced the words “would cause” to reflect the decision of the Working Group that account be taken of the fact that, at the time an interim measure is sought, there is often insufficient facts to provide proof that, unless a particular action was taken or refrained from being taken, harm would inevitably result. A number of delegations expressed concern that this formulation might make the threshold for obtaining an interim measure too low and result in excessive discretion being granted to the arbitral tribunal with respect to the issuance of an interim measure (A/CN.9/545, para. 25).

*Subparagraph (c)—“[preserving] [securing] assets”*

10. The Working Group took note that the drafting group, to be established at a later stage by the Secretariat to ensure consistency between the linguistic versions, should consider using wording along the lines of “preserving assets”, instead of “securing assets”, to indicate that what is intended to be covered is the preservation of assets and that this should not be interpreted as requiring a legal guarantee or security in all cases (A/CN.9/545, para. 26).

*Subparagraph (c)—“preliminary”*

11. The Working Group may wish to further consider whether to maintain or delete the word “preliminary”, which was viewed as potentially misleading by some delegations at the thirty-ninth session of the Working Group (A/CN.9/545, para. 26).

*Subparagraph (d)—preserving evidence*

12. Notwithstanding the view that subparagraph (d) was superfluous in some legal systems, the Working Group agreed to retain subparagraph (d) on the basis that the

presentation of evidence was not necessarily adequately dealt with by all domestic rules of civil procedure (A/CN.9/545, para. 27).

### Paragraph (3)

#### *Chapeau*

13. The inclusion of the phrase “The party requesting the interim measure of protection shall satisfy the arbitral tribunal that” reflects the Working Group’s decision to provide a neutral formulation of the standard of proof, while establishing clearly that the burden of proof lies on the requesting party (A/CN.9/545, para. 28).

#### *Subparagraph (a)—“irreparable harm”*

14. The Working Group may wish to further discuss the term “irreparable harm”, which was considered as too narrow in the commercial context where most harm may be cured by monetary compensation, whereas others pointed out that the notion of “irreparable harm” is well known in many legal systems and constitutes an ordinary prerequisite for ordering an interim measure (A/CN.9/545, para. 29).

#### *Subparagraph (a)—“is likely to result”*

15. For the same reasons as explained above in paragraph 9, the words “will result” have been replaced by the words “is likely to result” (A/CN.9/545, para. 30).

#### *Subparagraph (a)—“the party against whom the measure is directed”*

16. The wording of this paragraph has been modified to ensure consistency with the decision made by the Working Group that the phrase “the party against whom the measure is directed”, should be retained instead of the phrase “the party affected by the measure” (A/CN.9/545, para. 54). For the sake of consistency, this modification has been applied to paragraph 7, subparagraphs (a), (b) and Variant A of subparagraph (e) of the revised draft (see paras. 35, 44 and 49, below).

#### *Subparagraph (b)*

17. The Working Group adopted subparagraph (b) without modification (A/CN.9/545, paras. 31 and 32).

### Paragraph (4)

18. The drafting of paragraph (4) reflects the decision of the Working Group that the wording in square brackets “[Subject to paragraph (7)(b)(ii),] [except where the provision of a security is mandatory under paragraph (7)(b)(ii),]” should be deleted, as the remainder of paragraph (4) makes it clear that the arbitral tribunal retains the right, in all circumstances, to require the provision of security as a condition to granting an interim measure of protection (A/CN.9/545, paras. 33 and 34).

### Paragraph (5) (*paragraph 6 of the previous draft*)

#### *Placement of paragraphs 5 and 6*

19. The revised draft reflects the decision of the Working Group that placing paragraph (6) before paragraph (5) would appropriately emphasize the obligation of the parties to inform the arbitral tribunal of any change in the circumstances on the

basis of which the interim measure had been granted (A/CN.9/545, paras. 39 and 44).

*Communication of information to both parties*

20. The second sentence of paragraph 5 mirrors the first sentence of article 24 (3) of the UNCITRAL Model Law, in order to address the decision of the Working Group that all information supplied to the arbitral tribunal by one party pursuant to that paragraph should also be communicated to the other party (A/CN.9/545, para. 45).

*“from the time of the request onward”*

21. As decided by the Working Group, the words “from the time of the request onward” in the previous draft have been deleted given that the point in time at which the duty to inform arises is evident from the remainder of the paragraph, particularly from the words “on the basis of which the party sought the interim measure of protection” (A/CN.9/545, para. 46).

*“sought”*

22. To clarify the duty to inform, the word “sought” has been replaced by “made the request for” (A/CN.9/545, para. 46).

**Paragraph (6) (paragraph (5) of the previous draft)**

*Placement of paragraph (6)*

23. For the reasons expressed in the context of the discussion of paragraph (5) of the revised draft, (see above, para. 19), the Working Group decided that paragraph (6) would be renumbered paragraph (5), and paragraph (5) be renumbered paragraph (6) (A/CN.9/545, paras. 39 and 44).

*“modify or terminate”*

24. For the sake of completeness and for better consistency between draft articles 17 and 17 bis, the words “modify or terminate” have been amended to read “modify, suspend or terminate” (A/CN.9/545, para. 35).

*“[in light of additional information or a change of circumstances]”*

25. The Working Group agreed to delete the words “[in light of additional information or a change of circumstances]” as contained in the previous draft, in view of the fact that arbitrators would generally explain in the text of their decision the reasoning they followed when deciding to grant an interim measure, and also that the words might be misread as unduly restricting the discretion of arbitrators when making the decision to grant an interim measure (A/CN.9/545, para. 36).

*Modification of an interim measure of protection on the initiative of the arbitral tribunal*

26. After discussion on whether the arbitral tribunal could modify or terminate on its own motion an interim measure of protection and, in the affirmative, on the conditions to

be fulfilled (A/CN.9/545, paras. 37 - 40), the Working Group agreed to amend the wording of paragraph 6, as reflected in the revised draft.

27. The Working Group may wish to consider whether the revised draft, which includes the words in brackets “it has granted” reflects its decision that the arbitral tribunal could only modify or terminate the interim measures issued by that arbitral tribunal, irrespective of whether it acted at the request of a party or on its own initiative (A/CN.9/545, para. 41).

### **Paragraph (6 bis)**

#### *General provision on liability*

28. Concern was expressed that, in contrast to paragraph (7)(b), no liability provision was included in the context of *inter partes* interim measures of protection, that were subsequently shown to have been unjustified (A/CN.9/545, paras. 48, 60 and 61). In support of establishing such a general liability provision, it was stated that, in either case, the measure could ultimately be found to have been unjustified to the detriment of the responding party. However, some opposition was expressed to the suggestion that paragraph (7)(b) should apply generally to both *ex parte* and *inter partes* measures, as the strict liability imposed under paragraph (7)(b) was appropriate given the nature of an *ex parte* measure, due to the risks inherent in such procedure. It was also said that misrepresentation or fault in relation to the *inter partes* regime could be dealt with by procedural national laws.

29. Paragraph (6 bis) of the revised draft reflects the decision of the Working Group that a new paragraph, mirroring the text of paragraph (7)(b) in the context of *inter partes* measures should be included in the revised draft for further consideration (A/CN.9/545, para. 60). Paragraph (6 bis) also includes the following modifications as agreed by the Working Group in respect of the corresponding provision for *ex parte* interim measures (see comments in respect of paragraph (7)(b) of the revised draft, paragraph 43, below and A/CN.9/545, para. 66):

- the party against whom the measure is directed has a right to claim for compensation immediately after the interim measure has been granted by the arbitral tribunal and to obtain immediate awarding of damages; and
- damages for the interim measure are available only for the time period starting when the interim measure is granted and ending when the measure ceases to be in effect.

It should be noted that, as currently drafted, paragraph (6 bis) does not provide a solution for a possible discrepancy between the time when the measure is granted and the time when the measure enters into effect. The Working Group may wish to give further consideration to that issue.

30. When discussing paragraph (6 bis), the Working Group may wish to bear in mind other concerns that were raised at its previous session concerning the fact that the reference to damages and the circumstances when damages might be payable was not sufficiently defined as it could cover both direct and indirect or consequential damages caused by the measure, or be granted depending on whether the measure was found to be justified or unjustified. Diverging views were expressed as to whether a wider definition of damages (which would provide

appropriate safeguards) or a more limited one (restricting the scope of the rule to direct damages) should be retained (A/CN.9/545, para. 64) and as to whether the requesting party should be liable only if the measure was ultimately found to have been unjustified. Questions were raised as to the meaning to be attributed to the word “unjustified” and whether the notion of an “unjustified” measure should be considered per se, or in the light of the results on the merits. It was strongly felt that the final decision on the merits should not be an essential element in determining whether the interim measure was justified or not (A/CN.9/545, para. 65). It was said that the phrase “to the extent appropriate” should be maintained, to show that the measure is legitimate. Other views were expressed stating that the bracketed text was not necessary, as it did not provide any new element. The Working Group may wish to further discuss these issues (A/CN.9/545, para. 68).

31. In preparation for the continuation of the deliberations of the Working Group on this topic, it was agreed that additional research on the liability regimes in the context of national laws on interim measures of protection was needed. Delegations were invited to provide information on the liability regimes contained in national laws relating to interim measures of protection. The information provided by delegations is contained in document A/CN.9/WG.II/WP.127.

### **Paragraph (7)**

#### *Subparagraph (a)*

*“[Unless otherwise agreed by the parties] [If expressly agreed by the parties]”*

32. The wording in square brackets “[Unless otherwise agreed by the parties] [If expressly agreed by the parties]” reflects the discussion of the Working Group on whether *ex parte* interim measures should be available by default or only when the parties have expressly agreed to opt into the legal regime created by paragraph (7). Some support was expressed for both options and the Working Group may wish to take a decision on that matter (A/CN.9/545, para. 52).

*“in exceptional circumstances”*

33. The Working Group did not reach consensus on whether the words “in exceptional circumstances” should be retained (A/CN.9/545, para. 53) and the Working Group may wish to continue its discussion on this matter.

34. The following views were expressed (A/CN.9/545, para. 53):

- one view was that these words were redundant given that the circumstances listed in subparagraphs (a)(i) to (iii) only referred to exceptional circumstances;
- another view was that it was necessary to clarify that the words “in exceptional circumstances” referred to those circumstances listed in subparagraphs (a)(i) to (iii) only;
- a contrary view was that the words should be retained to underscore that the *ex parte* measure should only be granted in truly exceptional circumstances. In support of that view, it was said that the circumstances listed in subparagraph (a) were not necessarily exceptional circumstances.

*“[against whom the measure is directed] [affected by the measure]”*

35. The Working Group agreed that the words “against whom the measure is directed” were preferable to the words “affected by the measure”, as the latter phrase was ambiguous in view of the multiplicity of parties potentially “affected” by an interim measure (A/CN.9/545, para. 54). This modification has been applied to paragraphs (3)(a), (7)(b) and Variant A of paragraph (7)(e) of the revised draft (see para. 16, above, and paras. 44 and 49, below).

“[when] [if the requesting party shows that]”

36. This bracketed wording reflects the suggestion that the phrase “the requesting party shows”, or any other phrase as may be agreed in the context of subparagraph (a)(iii) (see below, para. 40), be transposed to the chapeau of paragraph (7)(a) to make it clear that it applies to all the elements of paragraph (7)(a) and not only to subparagraph (a)(iii) (A/CN.9/545, para. 58). If this suggestion is adopted by the Working Group, the wording in subparagraph (a)(iii) will need to be adjusted accordingly.

*Subparagraph (a)(i)*

37. The Working Group found the substance of subparagraph (a)(i) to be generally acceptable (A/CN.9/545, para. 55).

*Subparagraph (a)(ii)*

38. The drafting reflects the decision of the Working Group to replace the word “circumstances” with the word “conditions” to better reflect the nature of the list contained in paragraph (3) (A/CN.9/545, para. 56).

39. The Working Group made no final decision on whether to retain subparagraph (a)(ii). A view was expressed that subparagraph (a)(ii), which only referred to “the circumstances set out in paragraph (3)”, could be misinterpreted as excluding the application of paragraphs (5) and (6) to *ex parte* interim measures. It was recalled that subparagraph (a)(ii) had been included for the avoidance of any doubt that all the prerequisites applying to the granting of an *inter partes* interim measure should also apply to an interim measure that was ordered *ex parte*. It was said that, if re-emphasizing that point cast doubt on whether or not the other paragraphs applied, then paragraph (a)(ii) should be deleted (A/CN.9/545, para. 56). The Working Group may wish to further consider this issue.

*Subparagraph (a)(iii)*

40. The Working Group made no final decision on whether the words “the requesting party shows” should be harmonized with the amended text agreed to in the chapeau of paragraph (3), which provides that “the requesting party satisfies the arbitral tribunal” (see above, para. 13). Some opposition was expressed to that proposal on the basis that a higher standard of proof should be required in respect of *ex parte* interim measures (A/CN.9/545, para. 57). The Working Group may wish to further discuss this matter.

41. However, the Working Group took note of a suggestion that the phrase “the requesting party shows” should be transposed to the chapeau of paragraph 7(a) to make it clear that it applies to all the elements of paragraph 7(a) and not only to subparagraph (a)(iii) (A/CN.9/545, para. 58). The revised draft takes account of that suggestion.

*Subparagraph (b) (subparagraph (b)(i) of the previous draft)*

42. The current drafting reflects the suggestion that the provisions contained in subparagraphs (b)(i) and (ii) of the previous draft should not be grouped together in one paragraph since those subparagraphs deal with different issues, respectively liability and security (A/CN.9/545, para. 62).

*Specific liability provision for ex parte interim measures*

43. As mentioned above under paragraphs 28 to 31, the Working Group agreed that it would continue its deliberations on the issue of the liability regime having regard to the liability provision to be discussed in the context of *inter partes* measures (A/CN.9/545, para. 60). If a general liability regime is included, the Working Group will need to consider whether an additional specific liability provision that applies in respect of *ex parte* interim measures is required.

*“[against whom it is directed] [affected by the measure]”*

44. Support was expressed for the retention of the first bracketed text for the sake of consistency with the words used in subparagraphs 3(a), 7(a) and Variant A of subparagraph 7(e) (A/CN.9/545, para. 67) (see paras 16 and 35, above, and para. 49, below).

*Subparagraph (c) (subparagraph (b)(ii) of the previous draft)*

45. The drafting of this subparagraph reflects the decision of the Working Group that, as a matter of consistency, it should be aligned with the wording used in paragraph (4) relating to the provision of security in the context of *inter partes* interim measures, except for the word “may” which could be replaced by the word “shall” (A/CN.9/545, para. 69).

46. The revised draft reflects the decision of the Working Group that in order to enhance the safeguards necessary in the context of *ex parte* interim measures, subparagraph (c) be a mandatory condition to the granting an *ex parte* interim measure (A/CN.9/545, para. 70).

*Subparagraph (d) (subparagraph (c) of the previous draft)*

47. Subparagraph (d) of the revised draft contains two variants. Variant 1 is, with some modification, based on the text contained in subparagraph (c) of the previous draft. As decided by the Working Group, the words “For the avoidance of doubt”, have been deleted (A/CN.9/545, para. 73).

48. Variant 2 of subparagraph (d) gives effect to a suggestion made at the previous session of the Working Group that, since there is no doubt that the arbitral tribunal has jurisdiction on the issue of security under paragraph (7)(c), the scope of subparagraph (d) should be restricted to paragraph (7)(b) (A/CN.9/545, para. 72).



The Working Group agreed to further discuss whether paragraph (7)(d) should apply to both subparagraphs (b) and (c) or only to paragraph (b), and to further consider a proposal to make it clear that the jurisdiction of the arbitral tribunal only applies until the award is made (A/CN.9/545, para. 72).

*Subparagraph (e) (subparagraph (d) of the previous draft)*

49. It is recalled that, after discussion, the Working Group decided that its deliberations in respect of this subparagraph should be continued at its next session on the basis of the two variants reproduced in the revised draft (A/CN.9/545, paras. 75-79 and 81). It is recalled that whilst support was expressed for Variant A of subparagraph (e) as it provided flexibility and some discretion for the tribunal in respect of when the responding party should be heard, concern was expressed that the proposal did not make sufficiently clear the point of time at which notice should be given. Should Variant B of subparagraph (e) be retained, the Working Group may wish to confirm whether the words “the party against whom it is directed” should also be retained (A/CN.9/545, para. 74) or whether, in the context of paragraph (e), the words “any party affected by the interim measure of protection” are preferred.

50. Some reservations were expressed as to the inclusion of a time period of forty-eight hours or any other specific time period, which might prove too rigid and inadequate, depending on the circumstances. It was also pointed out that introducing wording to allow the tribunal to consider another time and date as was appropriate in the circumstances might provide flexibility but might also make it illogical to maintain a reference to a fixed period of time within that same provision. A widely shared view, however, was that the inclusion of a specific time period served two purposes; first to underscore that the opportunity to be heard was urgent and also to put the arbitral tribunal on notice that it should be ready to reconvene to allow an opportunity for the responding party to be heard (A/CN.9/545, para. 79).

51. The Working Group agreed that the words “opportunity to be heard” should be replaced by “opportunity to present its case”, in order to encompass both a hearing of the responding party and a written submission from that party (A/CN.9/545, para. 80).

52. The drafting of subparagraph (e) will need to be revisited when the Working Group examines the question whether enforcement of an *ex parte* interim measure should be permitted (A/CN.9/545, para. 82).

*Subparagraph (f) (subparagraph (e) of the previous draft)*

53. The revised draft reflects the decision of the Working Group to simplify this subparagraph (A/CN.9/545, paras. 83 and 84) and to include a requirement that the material on which the application was based should be provided to the responding party (A/CN.9/545, para. 86).

54. The Working Group may wish to further consider whether the party benefiting from the measure should bear the burden of seeking its maintenance beyond twenty days (A/CN.9/545, para. 87), as provided for in the bracketed text in the revised draft.

*Subparagraph (g) (subparagraph (f) of the previous draft)*

55. The draft paragraph has been revised, taking account of the following proposals: (A/CN.9/545, paras. 91 and 92):

- One proposal was to replace the phrase “shall have an obligation to inform” by “shall promptly inform”. However, it was said that the word “promptly” was more appropriate in the context of a continuous obligation to inform of any change in circumstances. A view was also expressed that the requirement to “inform the arbitral tribunal” might be too narrow and that wording along the lines of “place before the tribunal” might be preferable.
- The paragraph was proposed to be redrafted along the following lines: “A party requesting an interim measure of protection under this paragraph shall [promptly inform] the arbitral tribunal of all circumstances relevant and material to the arbitral tribunal’s determination whether the requirements of this paragraph have been met”. With a view to clarifying that the arbitral tribunal retained the discretion whether or not to order an interim measure of protection, it was suggested that the reference to “whether the requirements of this paragraph have been met”, could be replaced by “whether the arbitral tribunal should make the order requested”. If this second alternative is preferred by the Working Group, the Working Group may wish to consider replacing the words “make the order requested” with the words “grant the interim measure”, for the sake of consistency with paragraph (1).
- Another view was that an effort should be made to introduce in the proposed text some of the flexibility reflected in the original formulation of subparagraph (f). To that effect, language referring to “circumstances that the arbitral tribunal is likely to find relevant and material to its determination” is maintained in the revised draft.

**F. Working paper on the settlement of commercial disputes:  
interim measures of protection: proposal by the International Chamber  
of Commerce, submitted to the Working Group on Arbitration  
at its fortieth session**

**(A/CN.9/WG.II/WP.129) [Original: English]**

On 2 February 2004, the Secretariat received a proposal from the Secretary-General of the International Court of Arbitration of the International Chamber of Commerce (“the ICC”) on revised draft articles 17 and 17 bis of the UNCITRAL Model Law on International Commercial Arbitration relating respectively to interim measures of protection ordered by arbitral tribunals and recognition and enforcement of interim measures of protection. The draft articles on which those comments are based are reproduced in documents A/CN.9/WG.II/WP.123, A/CN.9/WG.II/WP.125 and A/CN.9/545. The text of the proposal, including proposed revisions to articles 17 and 17 bis, is annexed to this note in the form in which it was received by the Secretariat.

**ANNEX**

**COMMENTS AND PROPOSAL FROM THE SECRETARY-GENERAL  
OF THE INTERNATIONAL COURT OF ARBITRATION OF THE ICC**

As you know, the ICC International Court of Arbitration very much appreciates the opportunity to participate as an Observer in the discussions of Working Group II (Arbitration) regarding possible modifications to Article 17 of the UNCITRAL Model Law on International Commercial Arbitration. We understand that the Model Law is designed to reflect a worldwide consensus on the principles and important issues of international arbitration practice that is acceptable to States of all regions. In this regard, we hope that our experience in having administered over 13 000 arbitrations throughout the world over the past eighty years may be useful to delegates as they consider whether or not to modify Article 17 and, if so, how.

The ICC Rules of Arbitration expressly allow parties to seek interim measures from both arbitral tribunals and State courts. In our cases, we have seen arbitral tribunals grant interim measures of protection, among other things, requiring production of documents, ordering a party to post a bank guarantee, enjoining a party from transferring shares and enjoining a party from calling a bank guarantee.

Of parties that sought interim measures from arbitral tribunals in ICC arbitrations, none did so on an *ex parte* basis (*i.e.*, without giving notice to the

other side). We did, however, have a case in early 2000, where a party applied to an arbitral tribunal for interim measures on an *inter partes* basis (*i.e.*, giving notice to the other side) and the arbitral tribunal granted the interim measure without first hearing from the opposing party. This, however, was apparently done in error, and the arbitral tribunal retracted its order upon the protest of the opposing party and apologized for acting prematurely.

We also had a case in 2001 where a party applied to an arbitral tribunal for an interim measure on an *inter partes* basis and the arbitral tribunal asked the opposing party not to take any steps concerning the assets at issue pending the arbitral tribunal's decision. The opposing party voluntarily complied with the arbitral tribunal's request. After receiving submissions from the opposing party, the arbitral tribunal granted the application for interim measures.

In light of our experience, we believe that the practice with respect to interim measures – particularly with regards to the way those applications are handled by arbitral tribunals – is still evolving. Indeed, we can identify no worldwide consensus with respect to the standards and practices concerning the granting of interim measures by arbitral tribunals. Accordingly, we believe that caution should be exercised when considering changes to Article 17, particularly if those changes would expand the existing power of arbitral tribunals to grant interim measures. With this in mind, we have the following comments on the current drafts of Article 17 and Article 17bis.

We believe that certain of the proposed modifications may well aid parties and arbitrators in the practice with respect to interim measures. Specifically, we believe that the articulation of standards for the issuance of interim measures (see draft Article 17, paragraph 3) will help parties in formulating their applications and help arbitral tribunals in evaluating the applications they receive. Similarly, we believe that setting forth standards governing the enforceability of interim measures (see draft Article 17bis, paragraphs 1 and 2) could aid State courts in evaluating the effect of such measures.

Other proposed changes, however, raise concerns for us. Specifically, those proposed modifications that would: (1) permit arbitral tribunals to issue interim measures on an *ex parte* basis (see draft Article 17, paragraph 7); and (2) allow such measures to be enforced by State courts – also, in certain circumstances, on an *ex parte* basis (see draft Article 17bis, paragraph 6).

Inclusion of such provisions in the Model Law would make the Model Law materially different from the arbitration laws in major centers of international arbitration (*e.g.*, Paris, Switzerland, London and New York). Such provisions would also conflict with many well-established arbitration rules – including the UNCITRAL Arbitration Rules. This could undermine the Model Law's serving as an international standard reflecting a worldwide consensus, thereby making it less useful to countries seeking to harmonize their arbitration law with that of other jurisdictions.

Based on our experience, we have no reason to believe that parties either expect or want their arbitral tribunals to have *ex parte* powers. Were the

Model Law amended to provide for them (and the amended Model Law enacted by State legislatures), knowledgeable parties might shy away from places of arbitration in Model Law countries and unwary parties might be caught by surprise. We believe that the Model Law will best serve to further the growth of international arbitration if its provisions are kept consistent with parties' reasonable expectations and common intentions.

This is especially so as the prospect of an arbitral tribunal issuing interim measures on an *ex parte* basis raises due process issues. The party that is excluded from an *ex parte* proceeding may never know all of what was communicated to the arbitral tribunal – particularly if communications were oral – and may have reasonable concerns that the arbitral tribunal has, by virtue of deciding the *ex parte* application, prejudged substantive issues in the case. In this way, an arbitral tribunal's granting of *ex parte* interim measures could undermine parties' confidence in the arbitral process and make arbitration a less attractive means of resolving disputes. Moreover, in those Model Law countries where the local judiciary is cautious about the development of arbitration, the provision of such powers may serve only further to undermine the development of arbitration.

In light of these concerns, we would suggest eliminating those provisions of the current draft of Article 17 and Article 17bis that grant arbitral tribunals the power to issue interim measures on an *ex parte* basis and make such measures enforceable by State courts. In their place, delegates might consider including provisions that would address the situation where an arbitral tribunal receives an *inter partes* application for interim measures upon which it believes it must act before the other side has had a full opportunity to respond. As mentioned above, we have had two cases where this situation has arisen. Permitting arbitral tribunals to grant preliminary measures freezing the *status quo* – based on applications that are communicated to all parties and granted with notice to all parties – could aid arbitral tribunals that receive emergency applications requiring decision before the opposing party can present its views. As the opposing party has yet to be heard, we would recommend that such preliminary measures not be enforceable by State courts pursuant to Article 17bis or other similar legislation. Rather, a party that violated such a measure could be subject to a claim for damages in the pending arbitration. Once both sides had been given an opportunity to be heard, the arbitral tribunal could issue an interim measure that would be enforceable in State courts pursuant to Article 17bis or similar legislation.

The following revised texts of Article 17 and Article 17bis reflect our suggestions. In so doing, we note that we are not suggesting that our proposed texts be incorporated into the Model Law itself. Rather, we believe that, in light of the evolving practice and absence of worldwide consensus in this area, any alternative formulation of Article 17 (including Article 17bis) that might ultimately be adopted would be best included in an appendix to the Model Law.

Lastly, we wish to note that the Chairman of the ICC International Court of Arbitration, Dr Robert Briner, has participated in the preparation of this letter and approved its contents.

#### **Suggested changes to article 17, paragraph 7**

(a) Unless otherwise agreed by the parties, the arbitral tribunal may ~~[-in exceptional circumstances,]~~ grant an interim measure of protection, without ~~notice~~ ~~to~~giving the party [against whom the measure is directed] [affected by the measure] an opportunity [to oppose the measure] ~~[to be heard]~~, when:

- (i) There is an urgent need for the measure;
- (ii) The circumstances set out in paragraph (3) are met; and
- (iii) The requesting party shows that it is necessary to proceed in that manner in order to ensure that the purpose of the measure is not frustrated before it is granted;

(b) The requesting party shall:

- (i) Be liable for any costs and damages caused by the measure to the party [against whom it is directed] [affected by the measure] [to the extent appropriate, taking into account all of the circumstances of the case, in light of the final disposition of the claims on the merits]; and
- (ii) Provide security in such form as the arbitral tribunal considers appropriate [, for any costs and damages referred to under subparagraph (i),] [as a condition to granting a measure under this paragraph];
- (iii) Give notice of the application for the measure to the party [against whom it is directed] [affected by the measure] at the time such application is made.

(c) [For the avoidance of doubt,] the arbitral tribunal shall have jurisdiction, inter alia, to determine all issues arising out of or relating to [subparagraph (b)], above;]

(d) [The party [against whom the interim measure of protection is directed] [affected by the measure granted] under this paragraph shall be given ~~notice of the measure and~~ an opportunity to oppose the measure and to be heard by the arbitral tribunal ~~[as soon as it is no longer necessary to proceed on an ex parte basis in order to ensure that the measure is effective]~~ [within forty-eight hours of the notice, or on such other date and time as is appropriate in the circumstances];]

(e) [Any interim measure of protection ordered under this paragraph shall be effective for no more than twenty days [from the date on which the arbitral tribunal orders the measure] [from the date on which the measure takes effect against the other party], which period cannot be extended. This subparagraph shall not affect the authority of the arbitral tribunal to grant, confirm, extend, or modify an interim measure of protection under paragraph (1) after the party [against whom the measure

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is directed] [affected by the measure] has been given ~~notice and~~ an opportunity [to oppose the measure] [and be heard;]

(f) [A party requesting an interim measure of protection under this paragraph shall have an obligation to inform the arbitral tribunal of all circumstances that the arbitral tribunal is likely to find relevant and material to its determination whether the requirements of this paragraph have been met;]

**Suggested changes to article 17bis paragraphs 1 and 6**

(1) An interim measure of protection issued by an arbitral tribunal, that satisfies the requirements of article ~~17, shall~~ 17 shall, with the exception of an interim measure of protection issued under article 17(7), be recognized as binding and, unless otherwise provided by the arbitral tribunal, enforced upon application [in writing] to the competent court, irrespective of the country in which it was issued, subject to the provisions of this article.

Paragraph (6) of article 17bis should be deleted in its entirety.





### III. TRANSPORT LAW

#### A. Report of the Working Group on Transport Law on the work of its twelfth session (Vienna, 6-17 October 2003)

(A/CN.9/544) [Original:English]

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## I. Introduction

1. At its thirty-fourth session, in 2001, the Commission established Working Group III (Transport Law) and entrusted it with the task of preparing, in close cooperation with interested international organizations, a legislative instrument on issues relating to the international carriage of goods by sea such as the scope of application, the period of responsibility of the carrier, obligations of the carrier, liability of the carrier, obligations of the shipper and transport documents.<sup>1</sup> At its thirty-fifth session, in 2002, the Commission approved the working assumption that the draft instrument on transport law should cover door-to-door transport operations, subject to further consideration of the scope of application of the draft instrument after the Working Group had considered the substantive provisions of the draft instrument and come to a more complete understanding of their functioning in a door-to-door context.<sup>2</sup>

2. At its thirty-sixth session, in July 2003, the Commission had before it the reports of the tenth (Vienna, 16-20 September 2002) and eleventh (New York, 24 March-4 April 2003) sessions of the Working Group (A/CN.9/525 and A/CN.9/526, respectively).

3. The Commission was mindful of the magnitude of the project undertaken by the Working Group and expressed appreciation for the progress accomplished so far. It was widely felt that, having recently completed its first reading of the draft instrument on transport law, the Working Group had reached a particularly difficult phase of its work. The Commission noted that a considerable number of controversial issues remained open for discussion regarding the scope and the individual provisions of the draft instrument. Further progress would require a delicate balance being struck between the various conflicting interests at stake. A view was stated that a door-to-door instrument might be achieved by a compromise based on uniform liability, choice of forum and negotiated contracts, which would not deal with actions against performing inland parties. It was also stated that involving inland road and rail interests was critical to achieve the objectives of the text. A view was expressed that increased flexibility in the design of the proposed

<sup>1</sup> *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3), para. 345.

<sup>2</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17* (A/57/17), para. 224.

instrument should continue to be explored by the Working Group to allow for States to opt in to all or part of the door-to-door regime.

4. The Commission also noted that, in view of the complexities involved in the preparation of the draft instrument, the Working Group had met at its eleventh session for a duration of two weeks, thus making use of additional conference time that had been made available by Working Group I completing its work on privately financed infrastructure projects at its fifth session, in September 2002. The Chairman of Working Group III confirmed that, if progress on the preparation of the draft instrument was to be made within an acceptable time frame, the Working Group would need to continue holding two-week sessions. After discussion, the Commission authorized Working Group III, on an exceptional basis, to hold its twelfth and thirteenth sessions on the basis of two-week sessions.<sup>3</sup> It was agreed that the situation of the Working Group in that respect would need to be reassessed at the thirty-seventh session of the Commission in 2004. The Working Group was invited to make every effort to complete its work expeditiously and, for that purpose, to use every possibility of holding inter-session consultations, possibly through electronic mail. The Commission realized, however, that the number of issues open for discussion and the need to discuss many of them simultaneously made it particularly relevant to hold full-scale meetings of the Working Group.<sup>4</sup>

5. Working Group III on Transport Law which was composed of all States members of the Commission held its twelfth session in Vienna from 6-17 October 2003. The session was attended by representatives of the following States members of the Working Group: Austria, Brazil, Cameroon, Canada, China, Colombia, France, Germany, India, Italy, Japan, Lithuania, Mexico, Morocco, Russian Federation, Singapore, Spain, Sweden, Thailand, United States of America and Uruguay.

6. The session was also attended by observers from the following States: Algeria, Antigua and Barbuda, Argentina, Bolivia, Bulgaria, Costa Rica, Cuba, Czech Republic, Denmark, Finland, Greece, Kuwait, Lebanon, Netherlands, New Zealand, Norway, Republic of Korea, Senegal, Sri Lanka, Switzerland, Tunisia, Turkey, Venezuela and Yemen.

7. The session was also attended by observers from the following international organizations:

(a) **United Nations system:** the United Nations Conference on Trade and Development (UNCTAD), the United Nations Economic Commission for Europe (UNECE);

(b) **Intergovernmental organizations invited by the Commission:** Intergovernmental Organisation for International Carriage by Rail (OTIF);

(c) **International non-governmental organizations invited by the Commission:** Association of American Railroads (AAR), Center for International

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<sup>3</sup> For the general discussion regarding the allocation of conference time to the various working groups, see *ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, paras. 270-275 and 277-278.

<sup>4</sup> *Ibid.*, paras. 205-208.

Legal Studies (CILS), *Comité Maritime International* (CMI), *Instituto Iberoamericano de Derecho Marítimo*, International Chamber of Shipping (ICS), International Federation of Freight Forwarders Associations (FIATA), International Group of Protection and Indemnity (P&I) Clubs, International Multimodal Transport Association (IMMTA), International Union of Marine Insurance (IUMI) and The Baltic and International Maritime Council (BIMCO).

8. The Working Group elected the following officers:

*Chairman:* Mr. Rafael Illescas (Spain)

*Rapporteur:* Mr. Walter De Sá Leitão (Brazil)

9. The Working Group had before it the following documents:

(a) Provisional agenda (A/CN.9/WG.III/WP.31);

(b) Draft instrument on the carriage of goods [wholly or partly] [by sea]: Note by the Secretariat (A/CN.9/WG.III/WP.32);

(c) Proposal by the Netherlands on the application door-to-door of the instrument (A/CN.9/WG.III/WP.33), and proposal by the United States regarding 10 aspects of the draft instrument (A/CN.9/WG.III/WP.34);

(d) Addendum to compilation of replies to a questionnaire on door-to-door transport and additional comments by States and international organizations on the scope of the draft instrument (A/CN.9/WG.III/WP.28/Add.1).

10. The Working Group adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Preparation of a draft instrument on the carriage of goods [wholly or partly] [by sea].
4. Other business.
5. Adoption of the report.

## II. Deliberations and decisions

11. The Working Group began its review of the draft instrument on the carriage of goods [wholly or partly] [by sea] contained in the annex to the note by the Secretariat (A/CN.9/WG.III/WP.32) and discussed various proposals, including the proposal of the United States (A/CN.9/WG.III/WP.34) regarding 10 aspects of the draft instrument. The Secretariat was requested to prepare a revised draft of a number of provisions, based on the deliberations and conclusions of the Working Group. Those deliberations and conclusions are reflected in section III below.

### **III. Preparation of a draft instrument on the carriage of goods [wholly or partly] [by sea]**

#### **A. Methodology for continuation of work**

12. The Working Group heard that a group of Scandinavian countries had held informal discussions regarding the best way for the Working Group to proceed with its second reading of the draft instrument. It was proposed that, in light of the number of articles in the revised draft instrument (A/CN.9/WG.III/WP.32) and in light of the proposal made by the United States (A/CN.9/WG.III/WP.34), it might be best to proceed with discussions by grouping matters into core issues. It was suggested that the first major heading of issues could be “Scope of application” and that the first sub-set of issues under that heading could be “Conflicts with international and national legislation”, pursuant to which the following three groups of issues could be discussed: (1) contract of carriage; (2) performing parties and network liability and (3) localized and non-localized damage. It was proposed that the second sub-set of issues under the heading “Scope of application” could be “Geographical scope of the maritime leg” (article 2 of the draft instrument).

13. It was further proposed that a second major group of issues could be discussed under the heading “Freedom of contract”, and could consist of the following topics: the charter party exemption (article 2(3) of the draft instrument); treatment of ocean liner service agreements (OLSAs); mixed contracts of carriage and forwarding (article 9 of the draft instrument); the functional approach (e.g. article 11(2), free in and out, stowed, or FIOS, clauses); one-way or two-way mandatory provisions (article 88 of the draft instrument); and period of responsibility (article 7). It was stated that the topics in this group were based on the assumption that the instrument would otherwise be mandatory.

14. It was suggested that a third major group of issues could be discussed under the heading “Carrier obligations and liability”. This group of topics could include exemptions; limits and tacit amendment procedure; delay; and seaworthiness (as a continuing obligation). It was proposed that a discussion of these three major groups of issues could be followed by a discussion of the following four topics: shippers’ obligations; forum selection and arbitration; delivery of goods; and right of control.

15. Support was expressed for the methodology that the Working Group consider the core issues in the draft instrument. It was generally agreed that this examination could begin with a discussion of the issue of the scope of application of the convention and the issue of performing parties.

#### **B. Preliminary matter: title of the draft instrument**

16. The title of the draft instrument as considered by the Working Group was as follows: “Draft instrument on the carriage of goods [wholly or partly] [by sea]”.

17. It was observed that the Working Group might want to consider the extent to which the title should reflect the “maritime plus” (also referred to as “trans-maritime”) approach that had emerged at previous sessions of the Working Group as most likely to rally consensus in the preparation of the draft instrument.

18. A suggestion was made that consideration of the title of the draft instrument was premature in light of the future discussions to be held by the Working Group with respect to article 2 “Scope of application” and to the definition of “contract of

carriage” in article 1(a). However, support was expressed for the proposal that the Working Group had achieved a level of consensus with respect to the approach to be taken in the draft instrument that was sufficient for the square brackets to be simply removed from the existing title so that the draft instrument would be called the “Convention on the carriage of goods wholly or partly by sea”. Further refinements were suggested. One suggestion was that the word “international” should be added before the word “carriage”, so as to more accurately describe the contents of the instrument and to ensure consistency with existing conventions for the carriage of goods. Another suggestion was that, since the contract of carriage was the essence of the draft instrument, a reference to contracts should be made in the title, which would read “Convention on contracts for the international carriage of goods wholly or partly by sea”. In response to that suggestion, it was pointed out that inclusion of the word “contracts” could be misleading, in that it has been used in the past to describe conventions that, unlike the draft instrument, were more focused on the substantive requirements of the contract itself, such as its formation. Yet another suggestion was that, since UNCITRAL conventions often use the phrase “in international trade”, this phrase should be added to the end of the title. An additional proposal was made to delete the phrase “wholly or partly” currently in square brackets so as to avoid confusion with respect to multimodal instruments. Support was voiced for the contrary view that the inclusion of language indicating both the sea carriage aspect and other possible modes of transport was necessary in order to provide an accurate description of the subject matter of the convention.

19. The Working Group heard support for a number of different variations on the above proposals. While consensus on a specific title was not reached, support was expressed for the view that the title of the draft instrument should reflect its focus on maritime transport, as well as the possible coverage of other modes of transport. The Working Group decided to retain the current title unchanged for the purposes of future discussion.

## **C. Consideration of core issues in the draft instrument**

### **1. Scope of application and performing parties**

#### *(a) General discussion*

20. The Working Group heard statements by the delegation of Italy (made also on behalf of the Netherlands) that, in order to promote a pragmatic approach to the draft instrument and to facilitate the work of the Working Group, its earlier proposal (contained in document A/CN.9/WG.III/WP.25) would be withdrawn to favour the adoption of a limited network system in article 8 of the draft instrument. Italy and the Netherlands remained convinced that a uniform liability regime applicable throughout the door-to-door period of the carriage of goods would be the clearest and simplest solution, but had realized, based upon the debate at the eleventh session of the Working Group, that such a solution would not obtain sufficient support.

21. The Working Group heard that Italy and the Netherlands would support the proposal of the United States with respect to scope of application and performing parties (as it appeared in section I of document A/CN.9/WG.III/WP.34), subject to some minor changes. It was proposed that the first change should be that the

provisions of the draft instrument apply from the time the goods are taken over by the carrier to the time of their delivery to the consignee, subject to the limited network exception contained in article 8 of the draft instrument, and that the reference to national law that appeared in square brackets in that draft provision should be deleted. It was suggested that such deletion was necessary to avoid the danger that international law could be superseded by national law. The second change suggested was that in addition to the carrier, the provisions of the draft instrument should also apply to those performing parties that operate in the port areas, which were referred to as “maritime performing parties”, for which a definition would be required. The third suggestion was that the provisions of the draft instrument should not apply to performing parties that are not maritime performing parties. The fourth suggestion was that all of the provisions of the draft instrument that make reference to performing parties should be reviewed so that in those provisions relating to the liability of the carrier for acts or negligence of performing parties (e.g. draft articles 14(2) and 15(3)) reference should continue to be made to performing parties generally, whether maritime or not, while in those provisions that relate to the obligations and the liability of performing parties, reference should only be made to maritime performing parties. Amongst others, it was suggested that draft articles 15(1) and 15(4) should be revised to create a direct cause of action against maritime performing parties only. Similarly, it was suggested that the “Himalaya” protection of article 15(5) should be extended to maritime performing parties only.

22. By way of general presentation of working paper A/CN.9/WG.III/WP.34, the Working Group heard that the intention of the proposal was to begin shaping the basic structure of the draft instrument now that the Working Group had completed an initial review of possible provisions. It was stated that the working paper was intended to address the likelihood that creating a uniform liability regime would not be possible, and to present an overall package of compromises reached amongst competing interests in the industry. It was felt that the package represented both the highest level of uniformity that was achievable and a significant improvement over the current system.

23. With specific reference to section I of document A/CN.9/WG.III/WP.34 (“Scope of application and performing parties”), the Working Group heard that, in keeping with the overall proposal (which was referred to by its proponents as a “compromise position”), support was given to door-to-door coverage of the draft instrument on a limited network basis as currently set out in the draft instrument. However, it was recommended that the treatment of performing parties be altered so that only maritime performing parties, generally those who would have been covered in a port-to-port instrument, such as stevedores and terminal operators, and ocean carriers would be covered by the draft instrument. Non-maritime performing parties, such as inland truck and railroad carriers or warehouses outside of the port area, would be specifically excluded from the liability regime of the draft instrument. However, non-maritime performing parties would still be considered performing parties under the draft instrument because the contracting carrier would be responsible for their acts or negligence. It was further explained that it was felt that under this proposed regime, reference to “national law” in article 8 of the draft instrument would be inappropriate and unnecessary to protect the current liability regime applicable to inland carriers, and that the liability of inland performing parties would be based on existing law, whether that be a regional unimodal

convention or mandatory or non-mandatory domestic law, which may include tort. Automatic “Himalaya clause” protection would extend only to those performing parties who assumed liability under the draft instrument (i.e. to maritime performing parties only), and the ability of inland performing parties to rely on a “Himalaya clause” would be subject to their existing rights to do so under applicable national law. In response to a question, it was acknowledged that this proposal did not solve any existing problems for inland performing parties under current applicable national law, but that inland performing parties would be left in exactly the same position with respect to liability in which they were currently.

24. Strong support was expressed for the general principles and “compromise position” set out in section I of document A/CN.9/WG.III/WP.34. While some potential adjustments were suggested as, for example, with respect to the treatment of maritime performing parties in a non-Contracting State, it was strongly felt that the approach was the best one possible in the circumstances. Minority views were also expressed that the draft instrument should cover inland carriers and that a uniform liability system should still be considered.

25. While there was general support for the creation of different regimes for maritime and non-maritime performing parties, it was proposed that a reference to national law be kept in article 8(b), and it was suggested that this reference could be qualified by referring to national mandatory law that is similar to or based upon existing conventions. It was stated that the proposal in section I of document A/CN.9/WG.III/WP.34 did not solve all problems that a specific reference to national law would solve, since, for example, without a reference to national law in article 8(b), it would not be possible for the owner of goods to sue a contracting carrier on the basis of the national law governing the carriage of goods by road. It was also stated that if inland carriers were left out of the scope of the draft instrument, it could not be assured that claims against inland carriers would be available under the applicable national law, and that this would be detrimental to shippers. It was suggested that shippers could potentially enjoy greater recovery for claims under national law given the generally lower liability limits under maritime conventions, but it was pointed out that this was not necessarily the case, particularly with respect to the “per package” limitation rules contained in maritime conventions, coupled with the amount of container traffic and the incidence of high value/low weight goods. As a further qualification to the reference to national law, it was suggested that only mandatory national regimes that created better protection for owners of goods would prevail over the draft instrument. Some support was expressed for the position that a reference to national law should be maintained in article 8(b), although concern was raised with respect to this proposal in light of the Working Group’s intent to create as uniform a regime as possible under the draft instrument. Further, with respect to the proposed qualifications of the reference to national law, concern was expressed regarding what criteria would be used to decide whether national laws would meet the proposed qualification requirements under article 8(b), and whether this would increase the level of uncertainty in the scope of application.

26. It was suggested that the treatment of performing parties under the draft instrument and the possible reference to national law in article 8(b) were two separate matters that were not necessarily linked. It was suggested that the liability of the contracting carrier was the key aspect of article 8, which in turn had two



aspects, that of recourse action under article 8 and that of conflicts with other international conventions. In response, it was suggested that there was a substantial or pragmatic link between article 8 and the treatment of performing parties. It was explained that the proposal in section I of document A/CN.9/WG.III/WP.34 was very clearly dependent on the acceptance of both the exclusion of non-maritime performing parties from the liability regime under the draft instrument, and the deletion of the reference to national law in article 8(b), since the exclusion of inland carriers was intended to render the reference to national law unnecessary.

27. The Working Group was almost unanimous in support of the exclusion of non-maritime performing parties from the liability regime of the draft instrument as set out in section I of A/CN.9/WG.III/WP.34. In addition, there was strong support in favour of the second aspect of that proposal in deleting the reference to national law in article 8(b). One delegation expressed the view that there was no reason to exclude land carriers from the draft instrument. While a provisional decision was made to retain the reference to national law in article 8(b) in square brackets pending a final decision to be made at a future session, it was strongly felt that deletion of the reference to national law was a necessary component to the overall proposal. The Working Group took note of the fact that the proposal in section I of document A/CN.9/WG.III/WP.34 should be regarded as a single package, including both the exclusion of non-maritime performing parties from the liability regime and the deletion of the reference to national law in article 8(b).

(b) *Definitions of “maritime performing party” and “non-maritime performing party”*

28. The Working Group proceeded with a consideration of the definition of maritime and non-maritime performing parties. The Working Group heard proposals for possible definitions of “maritime performing party” and “non-maritime performing party”, and for adjustments to the existing definition of “performing party” set out in article 1(e) of the draft instrument.

29. The definitions proposed were as follows:

“(e) ‘Performing party’ means a person other than the carrier that physically performs [or undertakes to perform] any of the carrier’s responsibilities under a contract of carriage for the carriage, handling, custody, or storage of the goods, to the extent that that person acts, either directly or indirectly, at the carrier’s request or under the carrier’s supervision or control, regardless of whether that person is a party to, identified in, or has legal responsibility under the contract of carriage. The term ‘performing party’ includes maritime performing parties and non-maritime performing parties as defined in subparagraphs (f) and (g) of this paragraph but does not include any person who is retained by a shipper or consignee, or is an employee, agent, contractor, or subcontractor of a person (other than the carrier) who is retained by a shipper or consignee.”

“(f) ‘Maritime performing party’ means a performing party who performs any of the carrier’s responsibilities during the period between the arrival of the goods at the port of loading [or, in case of trans-shipment, at the first port of loading] and their departure from the port of discharge [or final port of discharge as the case may be]. The performing parties that perform any of the carrier’s responsibilities inland during the period between the departure

of the goods from a port and their arrival at another port of loading shall be deemed not to be maritime performing parties.”

“(g) ‘Non-maritime performing party’ means a performing party who performs any of the carrier’s responsibilities prior to the arrival of the goods at the port of loading or after the departure of the goods from the port of discharge.”

30. By way of presentation, the Working Group heard that two approaches had been envisaged in creating the definitions, namely, a functional approach and a geographical approach. The geographical approach had been chosen as the simpler of the two. It was proposed that the geographical area for the definition could be the “port”, although it was conceded that a definition of “port” could pose considerable difficulties, and would likely be defined with reference to national law. A further caveat added by the proponents of the definitions was that the final sentence of the proposed definition of “maritime performing party” was intended to deal with the situation where a maritime leg of the carriage was followed by a land leg, which was in turn followed by another maritime leg, but that this phrase would require refinement.

31. There was general agreement in the Working Group that these definitions were a good basis for continuing the discussion on how to define maritime and non-maritime performing parties. There was general agreement that a geographical approach to the definition was appropriate, and there was support for the suggestion that inland movements within a port should be included in the definition of a maritime performing party, as, for example, in the case of a movement by truck from one dock to the next. However, a widely shared view was that movement between two physically distinct ports should be considered as part of a non-maritime performing party’s functions. It was suggested that a rail carrier, even if it performed services within a port, should be deemed to be a non-maritime performing party. A caveat was raised that experience under national law in some States indicated that the application of the geographical approach (while generally appropriate), was likely to generate substantial litigation. It was suggested that the draft definition could clarify the situation where non-maritime performing parties carried out some of their activities in a port area, as, for example, in the loading of a truck for movement of the goods outside of the port. It was proposed that this clarification could be achieved by indicating that performing parties were those who carried out the carrier’s obligations in connection with the sea carriage. In response, it was noted that “performing parties” under the definition contained in draft article 1(e) were already qualified as those parties who carried out core functions pertaining to the carrier. It was suggested that it was slightly unclear whether the definition of a maritime performing party also concentrated on these core functions.

32. A second area of discussion concerned whether the phrase “or undertakes to perform” should be included in the draft definition. Support was expressed for the inclusion of this phrase and the deletion of the square brackets around it, since it was suggested that inclusion of the phrase would appropriately take the interests of claimants into account by recognizing a direct cause of action against each party in what could be a very long chain of subcontracts. An opposing view suggested that the inclusion of the phrase “or undertakes to perform” could cause problems in practice, since the performing party who simply undertook to perform would be responsible to the carrier, but that it would be difficult for the shipper to ascertain

the facts and determine against whom the action should be taken. The Working Group decided that the inclusion or exclusion of the phrase “or undertakes to perform” could be decided at a later stage, in conjunction with an analysis of the existing definition of “performing party” in article 1(e) of the draft instrument (see paras. 34 to 42 below) and in view of the overall balance for cargo liability in the draft instrument.

33. Another concern raised was whether the definition should deal with performing parties in non-contracting States. It was suggested that this matter, if appropriate in light of concerns with respect to forum-shopping and the issue of enforcement of foreign judgements, could be dealt with later in view of the convention as a whole. As a matter of drafting, it was suggested that the phrase “first port of loading” be changed to “next port of loading” in the proposed paragraph (f).

(c) *Definition of “performing party” in article 1(e)*

34. In addition to the definition proposed in paragraph 29 above, the Working Group considered the text of draft article 1(e), which read as follows:

“(e) ‘Performing party’ means a person other than the carrier that physically performs [or undertakes to perform] any of the carrier’s responsibilities under a contract of carriage for the carriage, handling, custody, or storage of the goods, to the extent that that person acts, either directly or indirectly, at the carrier’s request or under the carrier’s supervision or control, regardless of whether that person is a party to, identified in, or has legal responsibility under the contract of carriage. The term ‘performing party’ does not include any person who is retained by a shipper or consignee, or is an employee, agent, contractor, or subcontractor of a person (other than the carrier) who is retained by a shipper or consignee.”

35. By way of introduction, the Working Group heard that article 1(e) had not changed significantly in the redraft of the draft instrument, and that the historical aspect of the discussion could be found in the footnotes to article 1(e). It was also stated that the footnotes contained alternative language to that presented in the text of article 1(e) (see A/CN.9/WG.III/WP.32, footnotes 8-10).

36. With a view to broadening the definition of “performing party”, it was suggested that the square brackets around the phrase “undertakes to perform” should be removed. The Working Group was reminded that the relevance of the definition was to establish that the contracting carrier would be liable for the errors, faults, and omissions of performing parties in general. It was stated that the narrower definition resulting from deleting the phrase in square brackets would allow performing parties who undertake to perform and then who either do not perform or delegate that performance to another party to escape liability. Further, it was suggested that it would be inappropriate to subject those who undertake to perform and do not perform at all to a lower standard than those who undertake to perform and fail in their attempted performance. In response to concerns that so-called “paper carriers”, or those who do not actually perform the carriage, should not be held responsible based on their undertaking to carry, it was suggested that the language of the definition would simply allow a direct action against the performing party who was at fault, and that it would avoid a multiplicity of actions in working

through the chain of contracts to get to the same party. It was also suggested that failure to include the phrase in the definition could allow for the linkages in the chain of contracts to be broken. For these reasons, strong support was expressed for the inclusion of the phrase “or undertakes to perform”. It was suggested that this proposal should be further clarified to exclude remote defendants by inserting into the phrase the word “physically”, so that the performing party would have to “undertake to perform physically”. While it was suggested that it was implicit that those who undertook to perform with respect to the contract of carriage undertook to do so physically, there was also strong support expressed for this refinement of the original proposal.

37. Concern was expressed by some delegations that the draft instrument should not cover performing parties at all. In addition, the concern was again raised that the phrase “or undertakes to perform” would make it difficult for the shipper to identify all of those parties whom the contracting carrier had engaged to perform some aspect of the carriage, and that the contract would be between the performing party and the contracting carrier. It was suggested that inclusion of the phrase might create a multiplicity of actions against performing parties that would not necessarily be the proper defendants, which would result in no improvement over the situation where the shipper would simply bring action against the performing carrier and the contracting carrier. In addition, it was felt that inclusion of the phrase in the definition would violate the concept of privity of contract between the shipper and the contracting carrier.

38. Concern was also expressed regarding the limitation of the definition to those persons other than the carrier that perform “any of the carrier’s responsibilities under a contract of carriage for the carriage, handling, custody, or storage of the goods”, since it was felt that the definition should include all of the functions of the carrier rather than only those listed. It was also suggested that there was a potential anomaly in the definition, since in some cases the carrier could be performing the loading or discharging of the goods on behalf of the shipper, yet the definition referred to persons performing “at the carrier’s request or under the carrier’s supervision or control”.

39. Further concern was expressed that the inclusion of the phrase “undertakes to perform” made the definition too broad. In response to this and to a question whether the interaction of this definition and the period of responsibility in article 7 could mean that the performing party who failed to pick up the goods would be liable when the contracting carrier would not be liable, the Working Group heard that the period of responsibility of the performing party and of the carrier was intended to be the same, and that the liability of the performing party in his role as performing party would never be wider than the contracting carrier’s responsibility as contracting carrier. In addition, it was stated that the notion of undertaking physical performance would clarify the intended narrower scope of the definition. Another potential difficulty with the definition was raised in the situation where certain ports require that port operations are undertaken by administrative authorities.

40. The Working Group was urged to bear in mind the two separate aspects of the issue of performing parties: that of liability for the performing party, and that of liability of the performing party. It was suggested that these issues might be better dealt with in a substantive provision such as draft article 15 on the liability of

performing parties, rather than in a definition. It was felt by some delegations that this definition of “performing party”, while adequate in general terms for the moment, might have to be revisited in the context of a discussion of draft article 15.

41. Two matters with respect to the definition were clarified. First, it was emphasized that the definition should not include an employee or agent as a performing party. In addition, it was observed that if the Working Group decided to exclude non-maritime performing parties from the application of the draft instrument, language along the lines of the proposed definition in paragraph 29 above including both maritime performing parties and non-maritime performing parties would have to be included in this general definition in article 1(e).

42. The Working Group made a provisional decision that the phrase “undertakes physically to perform” should be included in the definition without square brackets in order to both broaden the definition and clarify its limits in terms of physical performance pursuant to the contract of carriage. The Working Group asked the Secretariat to consider adding an inclusive phrase, such as “among others”, “inter alia” or a reference to “similar functions”, to the list of the carrier’s functions, and to consider shortening the definition, among other possibilities by deleting the phrase “regardless of whether that person is a party to, identified in, or has legal responsibility under the contract of carriage” as noted in footnote 8 of the revised draft instrument (A/CN.9/WG.III/WP.32).

## **2. Scope of application and localized or non-localized damage (draft article 18(2))**

43. The text of draft article 18(2) as considered by the Working Group was as follows:

“[2. Notwithstanding paragraph 1, if the carrier cannot establish whether the goods were lost or damaged during the sea carriage or during the carriage preceding or subsequent to the sea carriage, the highest limit of liability in the international and national mandatory provisions that govern the different parts of the transport shall apply.]”

44. By way of introduction, the Working Group was reminded that article 18(2) was a new provision in the draft instrument, and that further alternative texts had been proposed (see A/CN.9/WG.III/WP.32, footnote 93).

45. It was stated that a key question with respect to article 18(2) was whether it was advisable to use the same limits of liability in the case of non-localized damage as in the case of localized damage, or whether regard should be had to the other possible limits that might apply with a view to choosing the highest one. It was also stated that a key question was whether it was appropriate to have a specific liability limit for non-localized damage. It was suggested that those issues would be difficult to decide until the limits of liability in article 18(1) had been chosen, and that if the “per kilogram” limit decided upon for article 18(1) by the Working Group was at the same level as that in the Hague-Visby Rules, it might be appropriate to look to unimodal transport conventions in order to select a higher limit for non-localized damage. In addition, it was suggested that regard to national mandatory provisions could also be had, particularly if the scope of application of the draft instrument was very broad and potentially encompassed long inland transport legs. Caution was expressed, however, that certain mandatory national provisions might have no liability limit at all, and that consequently, it might not be appropriate to look to

national law in this regard. It was also pointed out that different liability limits for localized damage and non-localized damage had been used in other instruments, for example in the 1980 Convention on International Multimodal Transport of Goods which contained a similar provision on localized damage, as did the UNCTAD/ICC Rules. For these reasons, it was proposed that article 18(2) should be maintained in the draft instrument.

46. A series of alternative proposals were presented with respect to maintaining article 18(2) in the draft instrument. It was suggested that article 18(2) should be maintained in the draft instrument but kept in square brackets, and that as a matter of drafting, the phrase “international and national mandatory provisions” should be changed to “international or national mandatory provisions”. A further refinement suggested was to keep article 18(2) in square brackets pending the insertion of liability limits in article 18(1), but to insert square brackets around the phrase “and national mandatory provisions” in order to mirror the current text in article 8. Another alternative suggested was that article 18(1) could establish the specific liability limit for localized damage, while article 18(2) could establish a second specific liability limit for non-localized damage without any reference to other liability limits in international and national mandatory provisions. There was some support for each of these alternative proposals.

47. There was strong support for the deletion of article 18(2). The Working Group was reminded that the greater the number of exceptions that were created to the broad application of the draft instrument, the more it could undermine the goals of predictability and uniformity. It was suggested that in order to achieve the maximum degree of uniformity possible, the limited network exception in article 8 should be kept as narrow as possible, and the application of article 8 would adequately cover the concerns expressed with respect to non-localized damage. It was further stated that article 18(2) was a repetition of the principle set out in article 8 with respect to localized damage but with a different allocation of the burden of proof. However, it was also suggested that article 8 and article 18(2) were not incompatible. In addition, it was reiterated that the liability limits in the Hague-Visby Rules were often much higher in practice than might appear at first sight, and that given the volume of container traffic and the “per package” liability limit set out therein, they were often much higher than those in the unimodal transport regimes where the liability limits for recovery were based only on weight. The Working Group was also reminded that it had decided that the emphasis in the draft instrument was appropriately placed on the maritime leg, and it was suggested that it was in keeping with this approach that the liability limit for non-localized damage should be that set out for the maritime leg of the transport.

48. With respect to the burden of proof in the case of non-localized damage, it was stated that if the liability limit was low, a carrier might not even attempt to prove where the damage occurred so as to limit a claimant’s recovery to a lower liability limit. In response, it was stated that carriers would be very interested in establishing where the damage occurred so that they could bring recourse action against the subcontractor who was responsible for the damage.

49. In support of the deletion of article 18(2), the Working Group was warned against drawing an artificial distinction between localized and non-localized damage, since the cargo in issue was intended to be maritime cargo, regardless of which leg of the transport it was on, and that the risks would thus be the same, the

values of the cargo would be the same, the parties involved would be the same, and the essence of which party insured the goods for what amount would also be the same. It was pointed out that the purpose of liability limits was closely connected to the liability system itself, and that they were part of the overall balance of the liability regime. It was suggested that it might not be appropriate to upset this regime simply because damage might occur outside of the sea leg. However, the importance of draft article 18(2) was emphasized, based on the view that damage to cargo was usually non-localized and that the apparent exception set out in article 18(2) risked becoming the rule, particularly since damage was often discovered only when the container was opened by the consignee, notwithstanding that some ports were capable of photographing containers to ascertain external damage.

50. The Working Group took note that opinions were fairly evenly divided between those who favoured the deletion of draft article 18(2) in its entirety, and those who favoured retaining it. Those in favour of deletion held that position firmly. However, some of those who favoured maintaining the provision for the moment did so with a number of nuances. Having noted the positions expressed during the discussion with respect to draft article 18(2), the Working Group decided that it would be appropriate to maintain the draft article in square brackets pending the decision of the Working Group on the liability limit set forth in draft article 18(1).

**3. Scope of application: definition of the contract of carriage and treatment of the maritime leg (draft articles 1(a) and 2)**

51. The text as of draft article 1(a) as considered by the Working Group was as follows (see A/CN.9/WG.III/WP.32):

“(a) ‘Contract of carriage’ means a contract under which a carrier, against payment of freight, undertakes to carry goods **wholly or partly** by sea from one place to another”.

52. The text of draft article 2 as considered by the Working Group was as follows (see A/CN.9/WG.III/WP.32):

“1. *Variant A of paragraph 1*

Subject to paragraph 3, this instrument applies to all contracts of carriage in which the place of receipt and the place of delivery are in different States if

(a) the place of receipt specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the place of delivery specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]

(d) [the contract of carriage is entered into in a Contracting State or the contract particulars state that the transport document or electronic record is issued in a Contracting State, or]

(e) the contract of carriage provides that this instrument, or the law of any State giving effect to it, is to govern the contract.

*Variant B of paragraph 1*

Subject to paragraph 3, this instrument applies to all contracts of carriage of goods by sea in which the place of receipt and the place of delivery are in different States if

(a) the place of receipt [or port of loading] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the place of delivery [or port of discharge] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]

(d) [the contract of carriage is entered into in a Contracting State or the contract particulars state that the transport document or electronic record is issued in a Contracting State, or]

(e) the contract of carriage provides that this Instrument, or the law of any State giving effect to it, is to govern the contract.

1 bis. This instrument also applies to carriage by inland waterway before and after the voyage by sea as well as to carriage by road or by rail from the place of receipt to the port of loading and from the port of discharge to the place of delivery, provided that the goods, during the sea voyage, have been unloaded from the means of transport with which the land segment of the carriage is performed.

*Variant C of paragraph 1*

Subject to paragraph 3, this instrument applies to all contracts of carriage in which the port of loading and the port of discharge are in different States if

(a) the port of loading specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the port of discharge specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or]

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]

(d) [the contract of carriage is entered into in a Contracting State or the contract particulars state that the transport document or electronic record is issued in a Contracting State, or]

(e) the contract of carriage provides that this instrument, or the law of any State giving effect to it, is to govern the contract.



“2. This instrument applies without regard to the nationality of the ship, the carrier, the performing parties, the shipper, the consignee, or any other interested parties.

“3. This instrument does not apply to charter parties, [contracts of affreightment, volume contracts, or similar agreements].

“4. Notwithstanding paragraph 3, if a negotiable transport document or a negotiable electronic record is issued pursuant to a charter party, [contract of affreightment, volume contract, or similar agreement], then the provisions of this instrument apply to the contract evidenced by or contained in that document or that electronic record from the time when and to the extent that the document or the electronic record governs the relations between the carrier and a holder other than the charterer.

“5. If a contract provides for the future carriage of goods in a series of shipments, this instrument applies to each shipment to the extent that paragraphs 1, 2, 3 and 4 so specify.”

(a) *General discussion regarding the three variants of draft article 2(1)*

53. It was recalled that Variant A was based on the original text of the draft instrument, which did not distinguish between the various modes of transport that might be used for carrying the goods to determine the sphere of application of the draft instrument. Variant B was meant to emphasize that the scope of the draft instrument should be defined by reference to maritime transport, with possible extensions inland, provided that the goods, during the sea voyage, were unloaded from the means of transport with which the land segment of the carriage was performed. The effect of Variant B was to exclude the application of the draft instrument, for example where goods were carried by road and the trailer in which they were contained had been loaded onto a ship during a maritime segment of the overall carriage. Variant C was intended to emphasize the maritime nature of the draft instrument by establishing that it should only apply to those carriages where the maritime leg involved cross-border transport (see A/CN.9/WG.III/WP.32, footnotes 27, 31 and 35).

54. Limited support was expressed for Variant B. It was stated that a distinction based on whether or not the goods had been unloaded from their original means of transport appeared somewhat outdated. For example, in the context of containerized transport, goods would often be downloaded or uploaded without such operations requiring or justifying a change in the legal regime applicable to the cargo. It was observed that the purpose of Variant B was mainly to raise the issue of possible conflicts between international conventions covering different modes of transport. The Working Group decided that such possible conflicts should be dealt with not in the context of the provision establishing the sphere of application of the draft instrument but in the provisions of chapter 18, in particular draft articles 83 and 84, which were directly intended to deal with the relationship between the draft instrument and other conventions. In the context of that discussion, doubts were expressed as to whether draft articles 83 and 84 adequately covered the issue of potential conflicts of conventions. It was also pointed out that the relationship between the draft instrument and other transport conventions would largely depend on the liability limits that would be established in draft article 18. The continuation

of that discussion was postponed until the Working Group had reached a common understanding regarding the scope of the draft instrument.

55. Considerable support was expressed in favour of Variant A. Among the reasons given for avoiding to focus on any specific mode of transport in the definition of the sphere of application of the draft instrument, it was stated that the scope of the draft instrument should be as broad as possible and avoid relying on technical notions such as “port”, the definition of which might be difficult to agree upon. In that context, it was generally agreed that the draft instrument should cover carriage of goods not only from “ports” traditionally located on the coast of a State but also from offshore terminals in the high sea and even from oil rigs located in the exclusive economic zone of a State, outside its territorial waters.

56. The prevailing view, however, was that the focus of the draft instrument on maritime transport should be reflected in the provision establishing its sphere of application. It was pointed out that the acceptability of the draft instrument might be greater if its scope made it clearly distinguishable from a purely multimodal transport convention. The initial draft of the instrument had attempted to establish such a distinction simply by stating that the draft instrument was intended to cover door-to-door transport involving a sea leg. However, it was agreed by most delegations that a further restriction to the scope should be introduced by establishing that the draft instrument would apply to door-to-door carriage of goods, whether unimodal or multimodal, provided that such carriage involved a sea leg and that such sea leg involved cross-border transport.

(b) *Draft articles 1(a) and 2(1)*

57. Having decided on the general policy that the draft instrument should cover door-to-door carriage of goods, whether unimodal or multimodal, provided that such carriage involved a sea leg and that such sea leg involved cross-border transport, the Working Group proceeded with the implementation of that policy, which could be envisaged either in the “Scope” provision or in the definition of “contract of carriage” (or possibly in both provisions).

58. With respect to subparagraphs (a) to (e) of paragraph 1 of draft article 2, general support was expressed for the deletion of subparagraph (d). As noted during the ninth session of the Working Group, it was widely held that, in modern transport practice, the place of conclusion of the contract was mostly irrelevant to the performance of the contract of carriage and, if electronic commerce was involved, that place might even be difficult or impossible to determine (see A/CN.9/510, para. 34).

59. No final decision was made on the text of subparagraph (c), currently between square brackets. It was decided that the text should be maintained between square brackets for continuation of the discussion at a future session.

60. A suggestion was made to improve on the text of subparagraph (e) to extend the benefit of the “paramount clause” by replacing at the beginning of the draft provision the words “the contract of carriage” by the words “the contract of carriage or any related contract” or the words “the contract of carriage or any contract related to the execution of the contract of carriage”. The Working Group took note of that suggestion.

61. The Working Group requested a small drafting group composed of several delegations to prepare wording based on a combination of Variants A and C, and designed to implement the policy regarding the sphere of application of the draft instrument. A first proposal made by the small drafting group was as follows:

“Article 1(a)

“Contract of carriage means a contract under which a carrier against payment of freight undertakes to carry goods by sea from a place in one State to a place in another State and may include carriage by other [mode] [means] of carriage preceding or subsequent to the carriage by sea.

“Article 2

“Subject to paragraph 3, this instrument applies to all contracts of carriage if

(a) the place of receipt [or port of loading] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the place of delivery [or port of discharge] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]

(d) the contract of carriage provides that this instrument, or the law of any State giving effect to it, is to govern the contract.”

62. While the proposal by the small drafting group was generally regarded as an improvement and a step towards achieving consensus over the sphere of application of the draft instrument, several concerns were expressed. One concern was that the proposed text might inappropriately exclude from the scope of the draft instrument those contracts that did not specify or imply that the carriage would be undertaken by sea but left it open whether part of the carriage would be undertaken by sea, or which part of the carriage would be carried out by sea. For example, carriage from Vancouver to Portland would be outside the scope of the draft instrument unless it had been specified in the contract that the goods would initially travel from Vancouver to Seattle by sea. In addition, under the proposed wording, carriage from Vancouver to Hawaii through Seattle would also be outside the scope of the draft instrument unless it had been specified in the contract that the goods would initially travel from Vancouver to Seattle by sea. The sea leg from Seattle to Hawaii alone would not meet the requirement that the sea leg should involve cross-border transport. A more general concern was raised that, since the draft instrument was intended not only to cover certain aspects of multimodal carriage but also to replace the existing unimodal regime governing the international carriage of goods by sea, there should be no ambiguity regarding the applicability of the draft instrument to maritime transport.

63. Various drafting suggestions were made to alleviate the above concerns. One suggestion was to add the words “expressly or impliedly” after the word “undertakes” in the proposed definition of “contract of carriage”. That suggestion

was intended to achieve a purely legal definition of the contract of carriage that would require no investigation regarding the actual routing of the goods to determine the applicability of the draft instrument. However, it was generally found that such drafting would be insufficient to address the concerns expressed regarding the scope of the draft instrument. It was also found that such wording might increase the risk for conflicts between unimodal transport conventions.

64. Another suggestion was that wording should be added to the proposed definition of the contract of carriage to the effect that, where the contract did not expressly or impliedly refer to a mode of transport and the voyage for which a given mode would be used, a contract of carriage would be covered by the draft instrument where it could be shown that the goods had actually been carried by sea.

65. Yet another suggestion was that the placement of the words “by sea” in the definition of “contract of carriage” might need to be reconsidered.

66. A further concern was expressed that the proposed definition of “contract of carriage” might be too broad in that it might include certain types of contracts (such as contracts for “slots” on-board vessels under charter parties) that should not be covered by the draft instrument. Based on that concern, a suggestion was made that, in order to be regarded as a “contract of carriage” under the draft instrument, a contract should be evidenced “by a transport document or an electronic record”. That suggestion was not adopted by the Working Group. It was generally felt that certain contracts of carriage not evidenced by a transport document (for example, in the context of short sea traffic) might need to be covered by the draft instrument and that the issue of the exclusion of charter parties from the scope of the draft instrument should be dealt with separately.

67. After discussion, the Working Group decided to continue its deliberations based on the proposal by the small drafting group. Although some support was expressed for maintaining Variant A as a possible alternative, the prevailing view was that all three variants should be deleted from the future revised version of the draft instrument. The small drafting group was requested to prepare a revised proposal, reflecting the views and concerns expressed in respect of its first proposal.

68. The second proposal prepared by the small drafting group was as follows:

“Article 1. Definitions

“For the purpose of this instrument:

(a)[(i)] Contract of carriage means a contract under which a carrier against payment of freight undertakes to carry goods by sea from a place [port] in one state to a place [port] in another state; such contract may also include an undertaking by such carrier to carry the goods by other modes prior to or after the carriage by sea.

[(ii) A contract that contains an option to carry the goods by sea shall be deemed to be a contract of carriage under paragraph (i), provided that the goods are actually carried by sea.]”

“Article 2. Scope of application

Subject to paragraph 3, this instrument applies to all contracts of carriage if

(a) the place of receipt [or port of loading] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the place of delivery [or port of discharge] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]

(d) the contract of carriage provides that this instrument, or the law of any State giving effect to it, is to govern the contract.”

69. The discussion focused on the definition of “contract of carriage”. Regarding the use of the word “place” or “port” in subparagraph (i), preference was expressed for the word “port” in view of its maritime connotation. However, in view of the difficulties anticipated in the definition of “port”, the prevailing view was that the more neutral word “place” could be used, in view of the focus on the sea carriage being expressed throughout the draft provision. As a matter of drafting, it was suggested that the second phrase in subparagraph (i) might read as follows: “In addition, such contract may also include an undertaking by such carrier to carry the goods by other modes prior to or after such international carriage by sea.”

70. A more fundamental concern was raised with respect to the drafting of both the definition of “contract of carriage” and the provision establishing the sphere of application of the draft instrument. It was stated that the definition of the contract of carriage should be limited to describing the substantive obligations under a contract of carriage (a contract under which a carrier against payment of freight undertakes to carry goods from a place in one State to a place in another State) and providing an indication that such carriage should comprise a maritime leg. It was also stated that the test of internationality established to trigger the application of the draft instrument should be dealt with not in the definition of “contract of carriage” but exclusively in the provision dealing with the scope of the draft instrument. Therefore, it was suggested that the notion that the sea leg should take place between two different States should be expressed in draft article 2, together with the remainder of the test of internationality set forth by the draft instrument. The Working Group took note of that concern.

71. With respect to subparagraph (ii), divergent views were expressed. One view was that the draft provision was necessary and should be further improved, possibly through the addition of an indication that the option to carry the goods by sea could be either expressly stated or implied in the contract. It was also suggested that the words “shall be deemed” should be replaced by “may be deemed”.

72. Another view was that subparagraph (ii) should be deleted, as a possible cause for conflict with other conventions. For example, if the contract stipulated that the carriage should be “by air” and the goods were actually shipped by sea, both the draft instrument and the Warsaw Convention could apply. It was pointed out that the draft instrument should not be open to misuse by a carrier who might have shipped goods by sea in breach of its contractual obligations. As to the situation where the mode of transport was not specified in the contract, it was stated

that it could be addressed by courts and that commercial parties should be encouraged to avoid such uncertainty in the contracts they entered into. As another objection to the text of subparagraph (ii), it was stated that the text was likely to introduce a confusion between contracts of carriage and freight forwarding contracts.

73. Yet another view was that the substance of subparagraph (ii) could be further discussed in the context of the provisions dealing with liability under the draft instrument. While it was generally felt that the text of subparagraph (ii) might need considerable redrafting, it was also felt that the draft instrument should provide for the situation where no specific mode of transport had been stipulated in the contract. Among various possibilities for redrafting subparagraph (ii), it was suggested that article 18(4) of the Montreal Convention might provide a useful model.

74. After discussion, the Working Group decided that the second proposal by the small drafting group should be kept for continuation of the discussion at a future session, subject to the relocation of subparagraph (ii) in square brackets outside of the definition of “contract of carriage” in article 1(a). The Secretariat was requested to prepare a revised draft, with possible variants, to reflect the various views and concerns expressed.

75. After the closure of discussion, another proposal for alternative wording for article 1(a) was made.\*

(c) *Draft article 2(2)*

76. The Working Group found the substance of paragraph (2) to be generally acceptable.

(d) *Draft article 2(3)*

77. There was broad agreement in the Working Group that certain types of contracts either should not be covered by the draft instrument at all, or should be covered on a non-mandatory, default basis. Such contracts would include those that, in practice, were the subject of extensive negotiation between shippers and carriers, as opposed to transport contracts that did not require (or where commercial practices did not allow for) the same level of variation to meet individual situations. The latter generally took the form of contracts of adhesion, in the context of which parties might need the protection of mandatory law.

78. Diverging views were expressed as to the best legislative technique to be used in excluding those contracts that should not be covered on a mandatory basis by the draft instrument. One view was that the traditional exception regarding charter parties should be maintained in the provision dealing with the scope of the

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\* “Article 1(a)

“Contract of carriage means a contract under which a carrier against the payment of freight undertakes to carry goods from a place in one state to a place in another state if:

(i) the contract includes an undertaking to carry the goods by sea from a place in one state to a place in another state; or

(ii) the carrier may perform the contract at least in part by carrying the goods by sea from a place in one state to a place in another state, and the goods are in fact so carried.

In addition, a contract of carriage may also include an undertaking to carry goods by other modes prior to or after the international carriage by sea.”

draft instrument. It was suggested that such a traditional exception should be complemented by a treatment of specifically identified types of contracts in respect of which the provisions of the draft instrument should not be mandatory. However, it was also suggested that such contracts should not be dealt with in draft article 2 but in chapter 19 dealing with freedom of contract. Pursuant to that view, it was suggested that the references to “contracts of affreightment, volume contracts, or similar agreements” currently between square brackets should be moved to chapter 19, with the possible addition of a reference to “ocean liner service agreements (OLSAs)”. It was recalled that document A/CN.9/WG.III/WP.34 contained detailed explanations regarding the practice of OLSAs and the reasons for which they should be excluded from the scope of the draft instrument. As to the possible inclusion of a definition of OLSAs, the following was proposed:

“(a) An “Ocean Liner Service Agreement” is a contract in writing (or electronic format), other than a bill of lading or other transport document issued at the time that the carrier or a performing party receives the goods, between one or more shippers and one or more carriers in which the carrier or carriers agree to provide a meaningful service commitment for the transportation by sea (which may also include inland transport and related services) of a minimum volume of cargo in a series of shipments on vessels used in a liner service, and for which the shipper or shippers agree to pay a negotiated rate and tender a minimum volume of cargo.

“(b) For purposes of paragraph (a), a “meaningful service commitment” is a service commitment or obligation not otherwise mandatorily required of a carrier under this Instrument.

“(c) For purposes of paragraph (a), a “liner service” is an advertised maritime freight transport service using vessels for the carriage of general cargo on an established and regular pattern of trading between a range of specified ports.

“(d) An Ocean Liner Service Agreement does not include the charter of a vessel or the charter of vessel space or capacity on a liner vessel.”

79. Another view was that paragraph (3) should be deleted and that the issue should be dealt with in the provisions of the draft instrument dealing with freedom of contract. In favour of avoiding a list of individual contracts to be excluded from the scope of the draft instrument, it was explained that such a list might be extremely difficult to agree upon. For example, in respect of charter parties, which were traditionally excluded from the scope of international conventions governing the carriage of goods by sea, it was stated that it might prove impossible to reach a common understanding as to the legal nature of a charter party and the manner in which such a document might be incorporated in subsequent contracts of carriage. It was stated that the dilution of the notion of “charter party” since 1924 (and the legal uncertainty in that regard) had only increased with the modernization of trade practices, a reason for which that notion should no longer be used in efforts to harmonize the law of international trade. Related notions such as “contracts of affreightment, volume contracts, or similar agreements” were described as even more imprecise and difficult to define than charter parties. Pursuant to that view, it was suggested that no attempt should be made to define such contracts in the draft instrument. Instead, it was suggested that the Working Group should focus on the

preparation of a general standard establishing the conditions under which a contract might be regarded as “freely negotiated”, in which case the provisions of the draft instrument should apply only as suppletive rules.

80. The Working Group expressed broad support for the idea that further attempts should be made to defining sets of criteria to be applied when determining the mandatory application of the draft instrument. Instead of defining types of contracts to be excluded from the application of the draft instrument, it might be easier to define situations where it would be inappropriate for the draft instrument to apply mandatorily. The following were described as situations where freedom of contract should prevail: the situation where a contract is freely negotiated; the situation where the focus of the contract is on the use of the vessel and not on the carriage of goods; the situation of non-liner trade; and the situation where the object of the chartering is the whole or a large part of the vessel. It was acknowledged that, even if such criteria could be devised, a margin of uncertainty to be decided upon by courts was unavoidable.

81. Yet another view was that, while the freedom of contract might need to receive broad recognition under the draft instrument, the mandatory nature of the instrument should be made clear in respect of third parties, where such third parties held rights under the draft instrument.

82. After discussion, the Working Group requested the Secretariat to prepare a revised draft, with possible variants, to reflect the above views and suggestions to the extent possible.

*(e) Draft article 2(4)*

83. Subject to possible reconsideration of the placement of paragraph (4) after discussion of chapter 19, the Working Group found the substance of the draft provision to be generally acceptable. It was decided that the words “[contract of affreightment, volume contract, or similar agreement]” should be retained in square brackets for further discussion. The Working Group took note of suggestions for possible improvement of the text. One suggestion was to add the words “or the consignee” at the end of the paragraph. Another suggestion was to delete the reference to “negotiable” transport document or electronic record to cover also the case where a non-negotiable document or electronic record had been issued.

*(f) Draft article 2(5)*

84. Subject to possible reconsideration of the placement of paragraph (4) after discussion of chapter 19, the Working Group found the substance of the draft provision to be generally acceptable.

**4. Exemptions from liability, navigational fault, and burdens of proof (draft article 14)**

*(a) Paragraphs 1 and 2 of draft article 14*

85. The text of draft article 14(1) and (2) as considered by the Working Group was as follows:



“Article 14. Basis of liability

“*Variant A of paragraphs 1 and 2*

“1. The carrier shall be liable for loss resulting from loss of or damage to the goods, as well as from delay in delivery, if the occurrence that caused the loss, damage or delay took place during the period of the carrier’s responsibility as defined in chapter 3, unless the carrier proves that neither its fault nor that of any person referred to in article 15(3) caused or contributed to the loss, damage or delay.

“2. Notwithstanding paragraph 1, if the carrier proves that it has complied with its obligations under chapter 4 and that loss of or damage to the goods or delay in delivery has been caused [solely] by one of the following events [it shall be presumed, in the absence of proof to the contrary, that neither its fault nor that of a performing party has caused [or contributed to cause] that loss, damage or delay] [the carrier shall not be liable, except where proof is given of its fault or of the fault of a performing party, for such loss, damage or delay].

“(a) [Act of God], war, hostilities, armed conflict, piracy, terrorism, riots and civil commotions;

“(b) Quarantine restrictions; interference by or impediments created by governments, public authorities, rulers or people [including interference by or pursuant to legal process];

“(c) Act or omission of the shipper, the controlling party or the consignee;

“(d) Strikes, lockouts, stoppages or restraints of labour;

“(e) Wastage in bulk or weight or any other loss or damage arising from inherent quality, defect, or vice of the goods;

“(f) Insufficiency or defective condition of packing or marking;

“(g) Latent defects not discoverable by due diligence;

“(h) Handling, loading, stowage or unloading of the goods by or on behalf of the shipper, the controlling party or the consignee;

“(i) Acts of the carrier or a performing party in pursuance of the powers conferred by articles 12 and 13(2) when the goods have become a danger to persons, property or the environment or have been sacrificed;

“*Variant B of paragraphs 1 and 2*

“1. The carrier is relieved from liability if it proves that:

“(i) It has complied with its obligations under article 13.1 [or that its failure to comply has not caused [or contributed to] the loss, damage or delay], and

“(ii) Neither its fault, nor the fault of its servants or agents has caused [or contributed to] the loss, damage or delay, or

“that the loss, damage or delay has been caused by one of the following events:

“(a) [Act of God], war, hostilities, armed conflict, piracy, terrorism, riots and civil commotions;

“(b) Quarantine restrictions; interference by or impediments created by governments, public authorities, rulers or people [including interference by or pursuant to legal process];

“(c) Act or omission of the shipper, the controlling party or the consignee;

“(d) Strikes, lockouts, stoppages or restraints of labour;

“(e) Wastage in bulk or weight or any other loss or damage arising from inherent quality, defect, or vice of the goods;

“(f) Insufficiency or defective condition of packing or marking;

“(g) Latent defects not discoverable by due diligence;

“(h) Handling, loading, stowage or unloading of the goods by or on behalf of the shipper, the controlling party or the consignee;

“(i) Acts of the carrier or a performing party in pursuance of the powers conferred by articles 12 and 13(2) when the goods have become a danger to persons, property or the environment or have been sacrificed;

“The carrier shall, however, be liable for the loss, damage or delay if the shipper proves that the fault of the carrier or the fault of its servants or agents has caused [or contributed to] the loss, damage or delay.

*“Variant C of paragraphs 1 and 2*

“1. The carrier shall be liable for loss resulting from loss of or damage to the goods, as well as from delay in delivery, if the occurrence that caused the loss, damage or delay took place during the period of the carrier’s responsibility as defined in chapter 3.

“2. The carrier is relieved of its liability under paragraph 1 if it proves that neither its fault nor that of any person referred to in article 15(3) caused [or contributed to] the loss, damage or delay.

“2 bis. It shall be presumed that neither its fault nor that of any person referred to in article 15(3) caused the loss, damage or delay if the carrier proves that loss of or damage to the goods or delay in delivery has been caused [solely] by one of the following events:

“(a) [Act of God], war, hostilities, armed conflict, piracy, terrorism, riots and civil commotions;

“(b) Quarantine restrictions; interference by or impediments created by governments, public authorities, rulers or people [including interference by or pursuant to legal process];

“(c) Act or omission of the shipper, the controlling party or the consignee;

“(d) Strikes, lockouts, stoppages or restraints of labour;

“(e) Wastage in bulk or weight or any other loss or damage arising from inherent quality, defect, or vice of the goods;

“(f) Insufficiency or defective condition of packing or marking;

“(g) Latent defects not discoverable by due diligence;

“(h) Handling, loading, stowage or unloading of the goods by or on behalf of the shipper, the controlling party or the consignee;

“(i) Acts of the carrier or a performing party in pursuance of the powers conferred by articles 12 and 13(2) when the goods have become a danger to persons, property or the environment or have been sacrificed;

“The presumption is rebutted if the claimant proves that the loss, damage or delay was caused by the fault of the carrier or any person referred to in article 15(3). Furthermore the presumption is rebutted if the claimant proves that the loss, damage or delay was caused by one of the cases listed in article 13(1)(a), (b) or (c). However, in such a case, the carrier is relieved of liability if it proves compliance with the duty under article 13.”

86. Information was provided to the Working Group that empirical data were being gathered with respect to the proposal in paragraphs 10 to 12 in A/CN.9/WG.III/WP.34 that the Hague-Visby liability limits should be maintained. It was suggested that the preliminary results of the analysis of containerized imports and exports to the United States, thought to be representative of the kind of goods that would be covered by the draft instrument, indicated that the average value of most cargo shipped was below the Hague-Visby per-package and weight limitations. Further analysis of this information was continuing with a view to presenting more refined results to the Working Group at its thirteenth session, and other delegations were encouraged to obtain relevant data from their domestic trade statistics for the information of the Working Group.

87. By way of general presentation of section III of A/CN.9/WG.III/WP.34 on exemptions from liability, navigational fault and the burdens of proof, the Working Group heard an explanation of the general approach taken. Paragraph 14 of A/CN.9/WG.III/WP.34 discussed whether the defences in draft article 14 of the draft instrument should be treated as exonerations or presumptions. It was suggested that in practice, there was no real difference between the two approaches since under the exoneration system, a carrier's right to rely on an exemption could still be lost if the cargo interests could prove the carrier's fault. It was proposed that the list of “excepted perils” in draft article 14 of the draft instrument should continue to be treated as exonerations in order to achieve greater predictability and uniformity in the application of the defences, given the substantial body of case law that had developed under the existing Hague and Hague-Visby approach. It was further suggested that with respect to the “excepted perils” themselves, the navigational fault defence should be eliminated and that the fire defence should be modified so as to accommodate the door-to-door nature of the draft instrument by limiting its operation to that of a maritime defence (see A/CN.9/WG.III/WP.34, paragraphs 13 and 16-17).

88. By way of further presentation, the Working Group heard the suggestion that a case for cargo damage was, in practice, a four-step process. In the first step, the cargo claimant was required to establish its prima facie case by showing that the

cargo was damaged during the carrier's period of responsibility. In that first step, the cargo claimant was not required to prove the cause of the damage, and if no further proof was received, the carrier would be liable for unexplained losses suffered during its period of responsibility. In the second step, the carrier could rebut the claimant's prima facie case by proving an "excepted peril" under article IV.2 of the Hague and Hague-Visby rules, and that that peril was the cause of the damage to the cargo. In step three, the cargo claimant had the opportunity to prove that the "excepted peril" was not the sole cause of the damage, and that the carrier caused some of the damage by a breach of its duty to care for the cargo. Once the claimant had shown that there were multiple causes for the damage, the analysis proceeded to step four, in which liability for the damage was apportioned between the different causes. It was suggested that the first three steps of this approach had worked well since their inception in the Hague Rules, and that this general approach should be preserved in the draft instrument.

89. Finally, the Working Group was cautioned that the elimination of the exception based on navigational error could have unintended consequences. It was suggested that in most cases where goods were lost or damaged at sea, the claimant would generally have a plausible argument that the carrier might have been able to reduce the loss by having made a different navigational decision, and that thus a navigational error had been made. Under the current law, that argument would not succeed because navigational error was listed as an "excepted peril". However, it was suggested that if navigational error was deleted from the list of "excepted perils", as the Working Group had decided it should be, and if the burden of proof was not accordingly adjusted, the carrier would have to prove the apportionment of the cause of the loss, which was considered to be virtually an "insuperable burden". The view was expressed that the practical result would be that the carrier would be fully liable in most cases for all of the damage when there was any navigational fault, and that it could render irrelevant the "excepted peril" provisions in most cases where the damage occurred at sea. (This issue is discussed further in paragraphs 127 and 129 below, regarding the burden of proof.)

90. The Working Group agreed to proceed with its examination of variants A, B and C of draft article 14 as set out in A/CN.9/WG.III/WP.32, first with a discussion on the general approach, next with a discussion of the "excepted perils", followed by a discussion on the burden of proof, and concluding with a discussion on concurrent causes of loss. Support was expressed for the general approach to draft article 14 outlined in paragraph 88 above. It was also suggested that the Working Group should, in its general discussion, decide on the preferred approach to the issue of the nature of the liability, be it strict or presumed fault or perhaps of another nature. Strong support was expressed for the view that the nature of the liability in draft article 14 should be based on presumed fault. In this regard, strong support was also expressed for the approach taken in the opening paragraph of variant A of draft article 14. In addition, the view was expressed that draft article 14 should not be examined in isolation, but that the balance of the allocation of risk between the parties should be looked at as a whole, and that draft article 13, with respect to the carrier's obligation of due diligence, should also be examined in this context. The Working Group was in general agreement with the approach that the carrier should be responsible for unexplained losses occurring during its period of responsibility, but that the carrier should then have an opportunity to prove the cause of the damage. In light of this general agreement, it was suggested that it was

unnecessary to use potentially charged words such as “fault”, “presumption” and “exoneration” in draft article 14, since they might be misinterpreted. A contrary view was expressed that the word “fault” need not be avoided, since it had been a part of the liability regime from the inception of the Hague Rules, and its meaning was unambiguous and not likely to cause confusion.

91. With respect to the discussion of variants A, B and C of draft article 14, strong support was expressed for variant A. The view was expressed that variant A was more in keeping with the classical approach to the liability of the carrier, and that it more clearly expressed that unexplained losses would remain the responsibility of the carrier. Certain refinements were suggested to the wording of variant A. One suggestion made was that paragraph 1 could be ended after the phrase “chapter 3”, and the rest of the paragraph deleted. The view was also expressed that the reference to article 15(3) in variants A and C was misleading and redundant, and that it should be deleted. There was some support for this suggestion. Another suggestion in this regard was to replace the phrase “person referred to in article 15(3)” with the phrase “performing party”. A further general suggestion was made that draft article 14 could follow the approach taken in existing unimodal transport conventions and start with a basic liability rule, for example, along the lines of “the carrier is liable for loss or damage to the goods occurring during the custody of the goods”, without a specific mention of fault, followed by a paragraph that set out the situations in which the carrier would be relieved from responsibility for the loss or damage.

92. Some support was expressed for variant B of draft article 14, particularly with respect to its treatment of the list of “excepted perils” as exonerations rather than presumptions. The suggestion was made that the overall approach of variant B was most like that in the Hague and Hague-Visby Rules, in that the carrier was not liable at all until the cargo claimant had proved that the loss occurred during the carrier’s period of responsibility, and that the list of “excepted perils” would then be applied, after which the cargo claimant would have an opportunity to rebut those exceptions, and prove that the loss resulted from another cause for which the carrier was liable, such as unseaworthiness. However, concern was expressed that variant B did not clearly express the carrier’s liability at all, and that paragraph 1 thereof stated that “the carrier is relieved from liability” without first having set out the carrier’s liability. The view was expressed in response that variant B did not need a paragraph comparable to paragraph 1 of variants A and C due to the closing paragraph of variant B.

93. No support was expressed for variant C.

94. As a matter of drafting, concern was expressed with respect to the addition of the phrase “or contributed to” in variants A, B and C in regard to the parties who had “caused or contributed to the loss, damage or delay”. The view was expressed that this phrase suggested that if the carrier was in any way responsible for any portion of the loss, even only 5 per cent of it, then the carrier would be liable for the entire loss. It was proposed that this phrase should be deleted, or that it should be clarified that the carrier was liable only to the extent it had contributed to the loss or damage.

95. The Working Group expressed a preference, on the whole, for the approach taken in variant A of draft article 14.

96. An informal drafting group composed of a number of delegations prepared a redraft of draft article 14, based upon the discussion in the Working Group on variants A, B and C. The text of the first redraft of draft article 14 that was proposed to the Working Group for its consideration was as follows:

“Proposed revision of draft article 14

“1. Subject to paragraph 2, the carrier shall be liable for loss resulting from loss of or damage to the goods, as well as from delay in delivery, if the [shipper] proves that

“(a) The loss, damage, or delay; or

“(b) The occurrence that caused the loss, damage, or delay took place during the period of the carrier’s responsibility as defined in chapter 3.

“2. Subject to paragraph 3, the carrier is relieved of its liability under paragraph 1 if it proves:

“[(i) That it has complied with its obligations under draft article 13.1, or that its failure to comply has not caused the loss, damage, or delay, and]

“(ii) That neither its fault, nor the fault of its servants or agents, [nor the fault of a performing party] has caused [or contributed to] the loss, damage, or delay; or

“that the loss, damage, or delay was caused by one of the following events:

“(a) [Fire defence]; or

“(b) ... ; or

“... [*Insert all of the remaining items to be included on the list here.*]

“3. If the [shipper] proves that the fault of the carrier, or the fault of its servants or agents, [or the fault of a performing party] also contributed to the loss, damage, or delay, then liability shall be apportioned in accordance with paragraph 4. [To the extent that the [shipper] proves that the loss, damage, or delay was caused by a failure of the carrier

“(a) To make [and keep] the ship seaworthy;

“(b) To properly man, equip, and supply the ship; or

“(c) To make [and keep] the holds and all other parts of the ship in which the goods are carried (including containers, when supplied by the carrier, in or upon which the goods are carried) fit and safe for their reception, carriage, and preservation,

“then the carrier is relieved of liability if it proves that it complied with its obligation to exercise due diligence as required under draft article 13.1.]

“4. [*Insert provision for apportionment of liability in cases of multiple causation; see draft article 14.3 & footnote 79 in WP.32.*]

97. By way of presentation, the Working Group heard that the proposed redraft of article 14 was not specifically intended to embrace either the exoneration or the presumption approach, but it was observed it was probably closer to a presumption approach. The Working Group also heard that, as redrafted, article 14(1) was

substantially the same as paragraph 1 in variants A and C. One minor change was that the word “shipper” had been placed in square brackets in paragraphs 1 and 3 of the redrafted article 14 in order to signal that the term used should be brought into conformity with article 63 of the draft instrument regarding who had a right to sue under the contract of carriage. In contrast to variant A, B or C of the draft instrument, the redrafted article 14(1) clarified which party was required to establish the prima facie case that the loss or damage occurred during the carrier’s period of responsibility. It was further suggested that the redrafted version of article 14(1) was intended to reflect the Working Group’s consensus that the carrier should be held responsible for unexplained losses, and thus included subparagraph (a), for the situation when the cause of the loss was unknown, and subparagraph (b) for the situation where the cause of the loss was known.

98. By way of further presentation, the Working Group heard that redrafted article 14(2) was intended to allow the carrier to prove why it should not be liable, and that subparagraph (ii) included the list of “excepted perils”, while the opening phrase of subparagraph (ii) corresponded to article IV.2.q of the Hague and Hague-Visby Rules. It was stated that, since it was unclear where the obligation with respect to seaworthiness should be placed in the scheme, two alternative approaches were presented: one in subparagraph (i) of redrafted article 14(2), and the other in square brackets in redrafted article 14(3). The treatment of the seaworthiness obligation in redrafted article 14(2) was intended to present it as an overriding obligation, while the treatment of the seaworthiness obligation in redrafted article 14(3) was intended to reflect the alternative that it be treated as another issue to be proved by the cargo claimant, subject to the carrier’s ability to prove its due diligence. Redrafted article 14(3) was intended to cover the step where the cargo claimant could show that the carrier contributed to the loss by proving an additional cause. It was pointed out that, if the cargo claimant was successful in this regard, resort would then be had to redrafted article 14(4) which would deal with the apportionment of the liability for the loss based either upon draft article 14(3) of the draft instrument or on the language in footnote 79 of A/CN.9/WG.III/WP.32.

99. The Working Group welcomed the redrafted version of article 14 as a positive step that might represent a possible way forward. There was general agreement that the text would have to be digested and considered over the next few months prior to the thirteenth session of the Working Group. A view was expressed that a careful assessment of the redrafted provision should be made so as to avoid the imposition of new burdens on the cargo claimant. Another concern raised was that the traditional way for the cargo claimant to prove that damage had occurred was for the claimant to present a clean bill of lading. However, it was explained that redrafted article 14(1) was intended to provide the cargo claimant with an option, in that subparagraph (a) covered the traditional method of presenting a clean bill of lading, while subparagraph (b) allowed the claimant to prove the occurrence where the damage to the cargo only manifested itself later. It was stated that, although there was a possibility that subparagraph (b) might be redundant, both possibilities (a) and (b) had been included in order to enhance the clarity of the provision.

100. Some requests were made for clarifications to the redraft. Concern was raised that redrafted article 14(1)(b) might not be broad enough to include damage that would take place over a continued period of time, such as damage caused by sea

water. It was suggested that the phrase “the occurrence that caused the loss, damage or delay” should be changed to “the loss, damage or delay took place” in redrafted article 14(1)(b) in order to accommodate continuing damage to goods, and so as to make the claimant’s burden of proof more manageable in that the claimant would not have to prove the actual cause of the loss or damage, but only that it occurred during the period of the carrier’s responsibility. There was some support for this view. However, there was also support for the view that the current language in redrafted article 14(3) appropriately and adequately covered the situation of continuing damage. It was also suggested that redrafted article 14(1) did not make it clear whether the presumption of fault of the carrier was the basis for liability. In response, it was clarified that the principles in variant A of draft article 14 were reflected throughout the paragraphs of the redrafted provision, but not in one single paragraph.

101. With a view to maximizing the benefit of consultations that were expected to take place before the thirteenth session of the Working Group, the informal drafting group prepared a second redraft of draft article 14, based upon the discussion in the Working Group on variants A, B and C of article 14 and the first redraft of article 14. The text of the second proposed redraft of draft article 14 submitted to the Working Group for its consideration was as follows:

“Proposed revision of article 14

“1. The carrier shall be liable for loss resulting from loss of or damage to the goods, as well as from delay in delivery, if the [shipper] proves that

“(a) The loss, damage, or delay; or

“(b) The occurrence that caused [or contributed to] the loss, damage, or delay

“took place during the period of the carrier’s responsibility as defined in chapter 3, unless [and to the extent] the carrier proves that neither its fault nor the fault of any person mentioned in article [15(3)] caused [or contributed to] the loss, damage, or delay.

“2. [The carrier is not liable under paragraph 1 if [and to the extent] it proves that the loss, damage, or delay was caused by] [It is presumed that neither the carrier’s fault nor that of any person mentioned in article [15(3)] has caused the loss, damage, or delay, if [and to the extent] the carrier proves that the loss, damage, or delay was caused by] one of the following events:

“(a) [Fire]; or

“(b) ...; or

“... [*Insert all the remaining items to be included on the lists here.*]

“unless [and to the extent] the [shipper] proves that

“(i) The fault of the carrier or a person mentioned in article [15(3)] caused [or contributed to] the event on which the carrier relies under this subparagraph; or

“(ii) Any event other than those listed in this subparagraph contributed to the loss, damage or delay.



“3. To the extent that the [shipper] proves [that there was] [that the loss, damage, or delay was caused by],

“(i) The unseaworthiness of the ship;

“(ii) The improper manning, equipping, and supplying of the ship; or

“(iii) The fact that the holds or other parts of the ship in which the goods are carried (including containers, when supplied by the carrier, in or upon which the goods are carried) were not fit and safe for the reception, carriage, and preservation of the goods,

“then the carrier is liable under paragraph 1 unless it proves that,

“(a) It complied with its obligation to exercise due diligence as required under article 13(1). [; or

“(b) The loss, damage or delay was not caused by any of the facts mentioned in (i), (ii) and (iii) above.]

“[4. In case of concurring causes that each have caused part of the loss, damage or delay, then the court shall determine the amount for which the carrier is liable in proportion to the extent to which the cause attributable to its fault has contributed to the loss, damage or delay.] [The court may only apportion liability on an equal basis if it is unable to determine the actual apportionment or if it determines that the actual apportionment is on an equal basis.]”

102. By way of presentation of the second redraft of article 14, the Working Group heard that paragraph 1 was an attempt to set out the basic rules with respect to the allocation of the burden of proof between the claimant and the carrier. It was explained that, as with the previous redraft of article 14, the claimant was required to prove that there had been a loss and that the loss could be attributed to the period of the carrier’s responsibility. The underlying approach was that the carrier should be held responsible for unexplained losses. It was observed that paragraph 2 of the second redraft contained two alternatives in square brackets in its chapeau, which reflected the continuing difference of views with respect to whether the “excepted perils” should be treated as exonerations from liability or presumptions of non-liability. The first of these alternatives was intended to reflect the exoneration approach, while the second was intended to reflect the presumption approach. It was further explained that the chapeau of paragraph 3 contained alternative language in square brackets that was intended to reflect a difference of views with respect to whether the claimant was required simply to prove the occurrence of the events in subparagraphs (i), (ii) and (iii), or whether it was necessary to prove that those events caused the loss, damage or delay. It was observed that paragraph 3(b) was in square brackets to indicate that this language was necessary only if the first alternative in the chapeau of paragraph three was chosen by the Working Group. The Working Group also heard that the informal drafting group had not had sufficient time to consider appropriate language for paragraph 4 and that the text proposed simply represented an attempt to illustrate the alternative views of the Working Group.

103. There was general agreement in the Working Group that, like the first redraft of article 14, no firm decision could be made with respect to this second redraft

before further consideration and consultations had taken place. However, a widely shared view was that this second redraft represented an improvement on previous drafts, and that it would be appropriate for the Working Group to use it as a basis for future work on article 14. One drafting observation made with respect to the redrafted article as a whole was that the phrase “shall be liable” and “is liable” were both used, and that consistency should be sought in this regard.

104. In reviewing paragraph 1 of the second redraft of article 14, the view was expressed that the paragraph substantially reflected the approach in variant A of article 14 that was favoured by most delegations. Strong support was expressed in the Working Group for the overall approach taken and the principles reflected in paragraph 1. A concern was raised that the provision was not clear enough with respect to the carrier’s ability to show that it was only partly at fault. There was support for the view that this should be clarified. In response to a suggestion, it was thought that the addition to paragraph 1 of the phrase “to the extent” similar to that in paragraph 2 would not be sufficient to alleviate this concern. In response to a concern with respect to how the claimant would meet its burden of proof in paragraph 1, it was reiterated that the claimant was in the best position to prove the damage and that it occurred during the carrier’s period of responsibility, since the claimant need only prove that the goods were delivered to the carrier in good condition and that the consignee received them in a damaged condition.

105. A few additional drafting changes were suggested with respect to paragraph 1. One proposed change was that the phrase “the carrier proves that neither its fault nor the fault of any person” required proof in negative terms, and that the drafting could be adjusted to require positive proof. It was noted in response that the Hague and Hague-Visby Rules used virtually identical wording in article IV.2.q, and that this was not a novel approach. A second change proposed was that the phrase immediately before subparagraph (a), “if the [shipper] proves that” should be deleted, but there was support for the proposal that the language should remain in the text so as to provide guidance with respect to which party had the burden of proof. A third change suggested was the word “shipper” that still appeared in square brackets could be replaced with the word “claimant”, which could then be defined with reference to article 63 of the draft instrument.

106. The Working Group next considered article 14(2) of the second redraft prepared by the informal drafting group. As with previous iterations of this paragraph, discussion in the Working Group again focused on whether the preferred approach to the list of “excepted perils” should be one of exoneration from liability or one based on presumption of non-liability. Similar views were presented to those expressed in paragraphs 87, 90, 97 and 102 above (see also para. 119 below). Again, there was support for the view that the presumption approach was preferable, while a minority view expressed a preference for the exoneration approach. The question was raised whether substituting a phrase such as “It is considered” for the phrase “It is presumed” in the second of the alternatives would alleviate the concerns of those who had expressed views against a presumption approach. However, a widely held view was that there was no specific preference for one approach over the other, particularly if, as expected, the legal outcome would be the same with either approach.

107. A few drafting concerns were expressed with respect to paragraph 2. One view was that the language in paragraph 2(ii) was superfluous, while other views

were expressed that this subparagraph was necessary since it encompassed different circumstances, where a shipper or claimant proved not only the fault of the carrier with respect to one of the “excepted perils”, but an additional event attributable to the carrier that did not appear on the list and that contributed to the loss or damage. A more widely shared concern was that the construction of the first alternative in paragraph 2 could cause confusion by inadvertently suggesting that the carrier had to prove that it was not liable for the loss, damage or delay under both paragraphs 1 and 2. There was support for the proposal that, if the first alternative in paragraph 2 was chosen by the Working Group, it should be clarified that paragraph 2 was intended to function as an alternative means to paragraph 1 by which the carrier could demonstrate its innocence. It was suggested that this intention should be made clear through the insertion of a phrase in paragraph 2 illustrating its relationship with paragraph 1.

108. The Working Group heard that in an attempt to bridge the gap between those delegations that favoured an exoneration approach to the “excepted perils”, and those that preferred a presumption approach, and based upon the discussion on variants A, B and C of draft article 14 and of the previous informal texts submitted for the consideration of the Working Group, one delegation had prepared a further redraft of paragraphs 2 and 4 of draft article 14. The text of the third redraft of paragraphs 1 and 2 of draft article 14 submitted to the Working Group for its consideration was as follows:

“2. If the carrier [, alternatively to proving the absence of fault as provided in paragraph 1] proves that the loss, damage or delay was caused by one of the following events:

“(i).....

Then its liability for such loss, damage or delay will arise only in the event the claimant proves that:

“(i) The fault of the carrier or of a person mentioned in article 14bis caused [or contributed to] the event on which the carrier relies under this paragraph; or

“(ii) An event other than those listed in this paragraph contributed to the loss, damage or delay.

“4. In case the fault of the carrier or of a person mentioned in article 14bis has contributed to the loss, damage or delay together with concurring causes for which the carrier is not liable, the amount for which the carrier is liable, without prejudice to its right to limit liability as provided by article 18, shall be determined [by the court] in proportion to the extent to which the loss, damage or delay is attributable to its fault.”

109. It was explained that the phrase in square brackets in the first line of this third redraft of paragraph 2 was intended to alleviate the concerns expressed above (see para. 107) with respect to making explicit the relationship between paragraphs 1 and 2. It was also indicated that the proposal was intended to include the full list of “excepted perils”, and that the second alternative in the second redraft of article 14(4) (see para. 101 above) referring to the so-called “50-50”

apportionment rule should be added after the first sentence in paragraph 4 of this third proposal (see below, paras. 140 to 144).

110. As with the previous drafts of article 14, there was general agreement in the Working Group that, while no firm decision could be made before further consideration and consultations had taken place, the third proposal represented a strong basis for bridging the gap between the preferred approaches to take with respect to the list of “excepted perils”. Unanimous support was expressed that the third redraft (in respect of paras. 2 and 4) and the second redraft (in respect of the remainder of draft article 14) should form the basis for future work on article 14(2), subject to those drafting suggestions indicated below. One view was expressed that, in addition to the redrafts, Variant A of article 14(1) and (2) as set forth in the note by the Secretariat (A/CN.9/WG.III/WP.32) should be maintained in the draft instrument for continuation of the discussion. While that view was not accepted by the Working Group, it was pointed out that the text of all variants, including Variant A in favour of which considerable support had been expressed, was reproduced in this report for further reference. In the context of that discussion, a suggestion was made that, as a general statement of policy, the draft instrument should contain a provision on compulsory insurance for carriers. Strong opposition was expressed to this suggestion.

111. A number of drafting improvements were suggested to paragraph 2 of the third proposed redraft. The Working Group heard that the text of paragraph 2(ii) could have the unintended consequence of suggesting that it was necessary for the shipper or claimant to prove both the additional cause for the loss and that it was outside the list of “excepted perils” in paragraph 2(i). There was support for the suggestion that a remedy for this inadvertent result could be to insert in paragraph 2(ii) after the phrase “an event other than those listed in this paragraph” the additional phrase “on which the carrier relies”.

112. Further drafting refinements that reflected previous discussions on the various article 14 redrafts were supported in the Working Group. It was agreed that the phrase “[and to the extent]” should be added after the opening “If” of paragraph 2, and that the phrase “only in the event” should be deleted in the text immediately following the list of “excepted perils”, and the phrase “if [and to the extent]” should be substituted in its place. A further refinement agreed upon was to clarify the relationship of paragraphs 2 and 3, and so as to avoid blocking recourse to paragraph 3. It was decided that the opening phrase “Without prejudice to paragraph 3”, should be added at the beginning of paragraph 2.

113. The Working Group further agreed that the square brackets surrounding the phrase in the opening line of paragraph 2 should be removed, to accommodate the concern expressed regarding possible misinterpretation of the relationship between paragraphs 1 and 2. An additional drafting suggestion was made that, instead of the phrase “then its liability ... will arise” in the text immediately following the list of excepted perils, a different phrase such as “then the carrier’s liability is maintained or continued”, or “then the carrier shall be liable for such loss, damage or delay” could be substituted. The Working Group requested the Secretariat to consider whether an appropriate text should be substituted in this regard, bearing in mind the caveat expressed that replacing the existing phrase with alternative language should not result in disregarding the intention that paragraph 2 was an alternative to paragraph 1.

114. It was also suggested that the relationship between paragraph 2 and paragraph 1 could be left unclear if the text in the third redraft remained as it was. In order to express the general agreement that in the situation where the shipper or claimant proved a cause for the damage attributable to the carrier but outside the list of “excepted perils” under subparagraph (ii) resort should be had back to paragraph 1, the Working Group agreed to add to subparagraph (ii) after its final period the sentence “In this case, liability is to be assessed in accordance with paragraph 1.”

115. One final drafting suggestion was made with respect to paragraph 2 of the third redraft. It was observed that the various drafting refinements outlined in the paragraphs above had clarified the relationship between paragraphs 1 and 2, and between paragraphs 2 and 3 of draft article 14, but that the counterproof provisions in subparagraphs (i) and (ii) of paragraph 2 might have become unclear. The suggestion was made to separate paragraph 2 into two separate sentences in order to clarify this potential problem. The Working Group requested the Secretariat to consider this potential problem and to suggest possible drafting improvements if it was deemed advisable.

116. After discussion, the Working Group approved the substance of the third redraft of article 14(2), subject to the drafting refinements agreed to in the paragraphs above, as the basis upon which to continue future work.

(b) *Article 14 list of “excepted perils”*

117. The Working Group next considered the list of “excepted perils” in draft article 14. There was support for the general view that the list of perils from draft article IV.2.c through article IV.2.q in the Hague and Hague-Visby Rules should be followed closely in order to preserve the certainty and predictability that had come with the development of a significant body of law on these issues. Two exceptions to this general approach were suggested, that of the deletion of article IV.2.a (error in navigation), and of a redrafting of article IV.2.b (fire exception) to reflect its limited application to the maritime leg of the transport. Support was also expressed for these proposals. A further suggestion was made to amend the notion of the overriding obligation of the carrier to provide a seaworthy ship in the Hague and Hague-Visby Rules so that the issue of the seaworthiness of the ship would become relevant only during the third step in an actual claim for cargo damage, i.e. when the cargo claimant could prove unseaworthiness as a cause of damage to rebut the carrier’s invocation of one of the “excepted perils”.

118. With respect to the use of the list of “excepted perils” from the Hague and Hague-Visby Rules generally, it was explained that the original rule was the result of a compromise position taken at the time in order to accommodate both the civil law and common law systems. Several views were expressed that the list of “excepted perils” was not necessary in many States, but that there was no objection to their continued inclusion in the draft instrument in order to accommodate all legal systems and to preserve the general body of law that had developed with the widespread use of the Hague and Hague-Visby Rules.

119. With respect to the issue of whether the list of “excepted perils” in draft article 14 should continue to be treated as exonerations or whether they should be treated as presumptions, support was expressed for both positions. A concern was

expressed that treating the listed perils as exonerations might result in confusion, since such treatment could lead to an interpretation that once one of the listed perils had been proved by the carrier, the claimant would have no right to rebut that exonerating evidence and prove that the event causing some or all of the damage was a result of the carrier's fault. One view expressed was the possibility that, for example, in the case of the subparagraph (d) exception for strikes, if the provision was treated as an exoneration rather than a presumption, a carrier could be exonerated for strikes that were a result of the carrier's own actions. It was widely felt that, irrespective of whether the exceptions to the general liability of the carrier were expressed by reference to the legal theory of exonerations or on the basis of a set of presumptions, it would be essential to preserve a rebuttal mechanism in the draft instrument.

120. The Working Group next considered the specific content of each of the listed perils. The view was expressed that the "act of God" exception in subparagraph (a) of all variants of draft article 14 was unnecessary due to the general force majeure provision set out in article IV.2.q of the Hague and Hague-Visby Rules and incorporated in the draft instrument. However, the view was expressed that if the "act of God" exception were deleted from the list of "excepted perils" it could risk erroneous judicial interpretation as a result of speculation regarding the reasons for its deletion from the list of "excepted peril" in the draft instrument. There was broad support for the proposal that the "act of God" exception should be maintained.

121. Support was expressed for the inclusion of piracy and terrorism in subparagraph (a) of the list of "excepted perils" in the draft instrument. While some doubts were expressed with respect to the precise definition of terrorism, it was observed that terrorism had been defined in a number of States. It was suggested that a precise definition of terrorism was unnecessary in any event, since it expressed a certain intention, and the important issue was whether the event was the fault of the carrier. The general view was that piracy and terrorism should be included in the list.

122. With respect to subparagraph (b) of the list of perils in the draft instrument, it was suggested that the square brackets be removed and the text be maintained, but that the language used should be the same as that used in the Hague and Hague-Visby Rules. There was support for this position, but the question was raised whether the phrase "including interference by or pursuant to legal process" could also include the situation where a cargo claimant arrested a ship. The suggestion was made to clarify the meaning of the phrase "interference by or pursuant to legal process".

123. With a view to broadening the scope of subparagraph (d) of the list of "excepted perils", the suggestion was made to add at the end of the subparagraph "for any cause whatsoever". However, doubts were raised as to this addition, since some strikes could be caused or contributed to by the acts of the carrier or the ship owner, such as where the owner refused the reasonable requests of the crew. It was suggested that the subparagraph might need to establish a distinction between general strikes and strikes that might occur in the carrier's business, and for which the carrier might bear some fault.

124. With respect to subparagraph (i) of the list of “excepted perils”, it was suggested that although this subparagraph did not appear in the Hague or Hague-Visby Rules, it was appropriate to include it in the draft instrument.

125. Some specific issues were raised with respect to the formulation of the list. Uncertainty was expressed with respect to the precise meaning of the phrase “restraints of labour” in subparagraph (d) of the list. In a similar vein, the word “rulers” in subparagraph (b) was questioned as meaningless in light of modern political realities. It was proposed that subparagraph (f) should clarify that the packing or marking should have been done “by the shipper”. In addition, there was support for the view that subparagraph (g) of the list in the draft instrument should make it clear that the latent defects referred to were those in the ship. Another suggested clarification of subparagraph (g) was that the phrase “not discoverable by due diligence” should be replaced by “not discoverable by vigilant examination”, although it was observed that the phrase “due diligence” came about as a result of the English translation of the words “diligence raisonnable” in the French text of the Hague Rules. Further, it was noted that if the phrase “due diligence” was used elsewhere, for example in draft article 13, it should also be repeated in subparagraph (g) in the interest of consistency. It was suggested that the phrase “or on behalf of the shipper” in subparagraph (h) should be deleted as confusing, since if the carrier handles the goods, it should be liable for any damage. It was also suggested that subparagraphs (a) and (b) should be broadened by adding the phrase “and all other events that are not the fault of the carrier”.

126. With regard to the fire exception currently in chapter 6 of the draft instrument, the view was expressed that the wording was unclear in that it seemed to lead to the conclusion that the fault of the carrier must be a personal fault. The question was raised whether this exception was necessary at all in light of other provisions making the carrier responsible for the acts of its servants or agents. However, it was suggested that if the fire exception was maintained for traditional reasons, the provision should be adjusted to clarify that the carrier is also responsible for the acts of its servants or agents. In addition, the view was expressed that the existence of the fire exception unfairly placed the burden of proof on the consignee. There was some support for these views, but another view was expressed that the fire exception should be the same as it was in the Hague and Hague-Visby Rules.

127. With respect to the elimination of the exception based on error in navigation, a number of delegations agreed with the position that there was a danger that the elimination of this exception could have the unintended effect outlined in paragraph 89 above. In response to this possibility, some delegations favoured the reinstatement of the exception for error in navigation, while others preferred to bear the potential problem in mind when considering the issue of burden of proof. Additional views were expressed in support of reinstating error in navigation as an exception, for example, that an error might be easy to characterize in hindsight, but that it was often the error of the master, forced to make rapid decisions in bad weather, and that no ship owner would generally interfere with his masters’ decisions in these circumstances. However, the prevailing view was that the deletion of the navigational error exception should be maintained, but also that the impact of that decision should be considered with respect to burdens of proof in discussions to come.

128. The Working Group was reminded that certain of the perils listed in the Hague and Hague-Visby Rules had been placed in a separate chapter 6 in the draft instrument, entitled “Addition provisions relating to carriage by sea [or by other navigable waters]”. The Working Group agreed to leave those exceptions in chapter 6 separate from draft article 14 for future consideration of where best to place them in the draft instrument.

129. The Working Group agreed that the list of “excepted perils” should be included in the draft instrument, and that the substance and content of the exceptions on the list should be inspired from the Hague and Hague-Visby Rules, including article IV.2.q. There appeared to be a slight preference in the Working Group for the list to be characterized as one of presumptions rather than exonerations. Several specific recommendations were made to refine the exceptions listed, as noted in paragraphs 120 to 126 above, and there was agreement that navigational fault should not be reinstated in the list as an “excepted peril”.

(c) *New paragraph 3 of draft article 14*

130. Discussion ensued in the Working Group with respect to draft article 14(3) as set out in the second redraft of article 14 (see para. 101 above). Views in the Working Group were divided between the two alternatives presented by the language in square brackets in the opening line of paragraph 3. There was support for the view that the shipper or claimant should only be required to prove the existence of the circumstances in subparagraphs (i), (ii) and (iii), since, it was suggested, it would be difficult enough to prove the events in (i), (ii) or (iii) without having to prove the causal link. A related view was that requiring the shipper to prove the circumstances in subparagraphs (i), (ii) and (iii) was excessively burdensome. Under that view, the mere allegation by the shipper that any of the events in subparagraphs (i), (ii) and (iii) had taken place should be sufficient to establish or restore the liability of the carrier. It was suggested that the word “alleges” should be introduced in square brackets as an alternative to “proves” in the opening words of paragraph 3. The opposing view was also expressed that the shipper or claimant should be required to prove that the circumstances in subparagraphs (i), (ii) and (iii) had caused the loss, damage or delay, since it was suggested that it would not be appreciably more difficult to prove the causal connection in addition to the event itself. It was observed that the new paragraph 3 should be considered in the context of the entire draft article 14. Paragraph 1 of article 14 permitted the claimant to prove the existence of loss, damage or delay without proving its cause. The carrier could explain that it should not be liable by proving a lack of fault or an exception under paragraph 2. If the carrier proved such a lack of fault or an exception, the claimant would have the burden to prove unseaworthiness and causation.

131. Between these two poles, a third view emerged that suggested that it was inappropriate for the loss, damage or delay to be wholly dissociated from the circumstances alleged in the subparagraphs to paragraph 3, and that the shipper or claimant should be required to prove that there was at least some sort of nexus between the alleged unseaworthiness and the damage. It was observed that the differences in opinion on this matter could be rendered less relevant in light of the actual conduct of a claim, since a carrier would often present evidence with respect to seaworthiness and the other matters in subparagraphs (i), (ii) and (iii) early in the conduct of the case in an effort to prove that it was not at fault with respect to the



damage. In addition, it was observed that, while the draft instrument might require the claimant to prove the unseaworthiness of the ship, it would not establish a standard of proof. Such a standard of proof would be governed by domestic law and would generally be easy to meet. It was further observed that causation of the damage was a relatively unimportant issue in the conduct of a claim, since even if there were circumstances that might suggest unseaworthiness, the carrier need not guarantee the seaworthiness of the ship, but needed only to prove that it had exercised due diligence in trying to maintain it.

132. Discussion ensued in the Working Group with respect to draft article 14(3) as set out in the second proposed redraft of article 14. The Working Group was of the view that paragraph 3 represented a good basis for the continuation of future work, and that the text should remain with its two alternative approaches for further consideration and consultation prior to making a decision on this matter. The Working Group requested the Secretariat to consider whether a third alternative could be proposed representing the approach that was part way between full proof of causation for the damage and mere allegation of the circumstances in subparagraphs (i), (ii) or (iii). It was suggested that the notion of “likelihood of causation” by one of the events in subparagraphs (i), (ii) or (iii) might need to be further explored. Wording along the lines of “[that the loss, damage, or delay could have been caused by]” was also suggested in that respect as a possible formulation for the third alternative.

133. As a matter of drafting, it was widely felt that, in the preparation of a revised draft of article 14 for continuation of the discussion at a future session, serious consideration should be given to replacing the word “shipper” by “claimant”. It was suggested that “claimant” could be defined as any person given the right of suit under article 63.

134. The Working Group also took note of a suggestion for restructuring paragraph 3 along the following lines:

“3. The carrier is not liable for loss, damage, or delay resulting from the unseaworthiness of the ship as [alleged] [proved] by the claimant, to the extent that the carrier proves that

“(a) It complied with its obligation to exercise due diligence as required under Article 13(1). [; or

“(b) The loss, damage or delay was not caused by any of the facts mentioned in (i), (ii) and (iii) above.]”.

(d) *Provision in draft article 14 dealing with the apportionment of liability in case of concurring causes for the damages*

135. The text of draft article 14(3) set forth in the note by the Secretariat was as follows:

“3. If loss, damage or delay in delivery is caused in part by an event for which the carrier is not liable and in part by an event for which the carrier is liable, the carrier is liable for all the loss, damage, or delay in delivery except

to the extent that it proves that a specified part of the loss was caused by an event for which it is not liable.”\*\*

136. The text of the corresponding provision in the second proposal for a redraft of article 14 was as follows:

“[4. In case of concurring causes that each have caused part of the loss, damage or delay, then the court shall determine the amount for which the carrier is liable in proportion to the extent to which the cause attributable to its fault has contributed to the loss, damage or delay.] [The court may only apportion liability on an equal basis if it is unable to determine the actual apportionment or if it determines that the actual apportionment is on an equal basis.]”

137. The text of the corresponding provision in the third proposal for a redraft of article 14 was as follows:

“4. In case the fault of the carrier or of a person mentioned in article 14bis has contributed to the loss, damage or delay together with concurring causes for which the carrier is not liable, the amount for which the carrier is liable, without prejudice to its right to limit liability as provided by article 18, shall be determined [by the court] in proportion to the extent to which the loss, damage or delay is attributable to its fault.”

138. A further draft proposal was submitted by one delegation in relation to paragraph 3 of article 14 as follows:

“3. When the carrier establishes that in the circumstances of the case, the loss of or damage to the goods or delay in delivery could be attributed to one or more of the events referred to in paragraph 2, it shall be presumed that it was so caused. The presumption is rebutted if and to the extent that the claimant proves that such loss or damage or delay is caused or contributed to by the fault of a carrier [or of a performing party].”

139. By way of explanation, the Working Group heard that the draft proposal had been taken from article 18(2) of the Convention on the Contract for the International Carriage of Goods by Road, 1956 as amended by the 1978 Protocol (“CMR”) with slight modifications. Under the first sentence, if the carrier could

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\*\* The text that has been deleted was included as a second alternative in the first draft of the draft instrument. As noted in paragraph 56 of A/CN.9/525, the first alternative received the strongest support in the Working Group and the decision was made to maintain only the first alternative in the draft instrument for the continuation of the discussion at a later stage. However, the Working Group decided to preserve the second alternative as a note or in the comments to the draft text, to permit further consideration of that alternative at a later stage (see A/CN.9/WG.III/WP.32, footnote 79):

[If loss, damage, or delay in delivery is caused in part by an event for which the carrier is not liable and in part by an event for which the carrier is liable, then the carrier is

(a) Liable for the loss, damage, or delay in delivery to the extent that the party seeking to recover for the loss, damage, or delay proves that it was attributable to one or more events for which the carrier is liable; and

(b) Not liable for the loss, damage, or delay in delivery to the extent the carrier proves that it is attributable to one or more events for which the carrier is not liable.

If there is no evidence on which the overall apportionment can be established, then the carrier is liable for one half of the loss, damage, or delay in delivery.]

establish that one or more of the listed events occurred during the carriage that *could*, in the ordinary case, have caused the loss, damage or delay, then the causation between the listed event and the loss would be presumed. It was further explained that the draft provision was intended to decrease the carrier's burden of proof of causation since, it was suggested, it was often difficult for the carrier to identify the cause of the damage and to establish the causation between the damage and the exonerative events, especially when the cargo was carried by container. It was further explained that, under the second sentence of proposed paragraph 3, the claimant was entitled to rebut the presumption by proving if and to what extent the fault of the carrier caused or contributed to the loss, damage or delay. Although it was proposed that this paragraph would apply even where the carrier's fault was the only cause of the damage to the goods, it was suggested the proposed paragraph could play a more important role where both the carrier's fault and the event listed in paragraph 2 jointly contributed to the loss. By way of further explanation, the Working Group heard that the proposed paragraph 3 was intended to be an alternative solution to the concern raised that the elimination of the navigational fault defence may have unintended effects (see A/CN.9/WG.III/WP.34, paragraph 15).

140. The view was expressed that the apportionment of liabilities in situations of concurring causes of the damage should not be dealt with under the draft instrument. Instead, it should be left to courts and arbitral tribunal to be decided upon according to applicable law. The prevailing view, however, was that an attempt should be made to cover the issue of apportionment of liabilities in the draft instrument. It was pointed out that, in cases of concurring causes, it was important to establish as a general rule that each party should prove the extent of causation, in particular in view of the exclusion of the nautical fault from the list of "excepted perils", it was stated that, where the goods had been damaged at sea, claimants could easily argue that navigational decisions had contributed to the damage (see A/CN.9/WG.III/XII/CRP.1/Add.4, paras. 5-10). The draft instrument should not place the carrier in a situation where the carrier would be liable for the entire loss where its fault had only contributed to a minor proportion of the damage. Accordingly, it was proposed that the issue of apportionment of liability should be discussed on the basis of footnote 79 to the text of draft article 14(3) set forth in the note by the Secretariat (A/CN.9/WG.III/WP.32).

141. That proposal was objected to on the grounds that it had not been favoured by the Working Group at its tenth session (see A/CN.9/525, para. 56). It was observed that a result of the proposed approach might be to transfer on the shipper the insuperable burden of proving the extent of causation in situations where the carrier's fault had clearly contributed to the damage. In the absence of such proof, the proposed approach offered a 50 per cent liability of the carrier, which was described as unfair to shipping interests. Support was expressed for the text of paragraph (3) of draft article 14 as set forth in the note by the Secretariat.

142. With a view to reconciling the various views that had been expressed, it was suggested that the draft instrument should avoid placing on any party the burden or proving the exact extent of causation. It was also suggested that the draft instrument should provide guidance to courts and arbitral tribunals to avoid certain causes of the damage being neglected, for example through excessive reliance on the doctrine of overriding obligations. The discussion focused on paragraph 4 of the third

proposed redraft of article 14. It was suggested that, in discussing the issue of apportionment of liability, it might be useful to bear in mind a distinction between concurring causes and competing causes for the damage. In the case of concurring causes, each event caused part of the damage but none of these events alone was sufficient to cause the entire damage (for example, where the damage was attributable to both weak packaging by the shipper and improper storage by the carrier). In the case of competing damages, the court might have to identify an event or the fault of one party as having caused the entire damage, irrespective of the fault of the other party (for example, where the goods were damaged as a result of artillery fire hitting the vessel, a decision might need to be made as to whether the artillery fire was to be regarded as the only cause of the damage, irrespective of the fault the master of the vessel might have committed by bringing the ship into a war zone). It was pointed out that, in this second situation, the doctrine of “overriding obligations” would often apply. It was suggested that draft article 14 dealt only with the situation where concurring faults were at stake and not with the second situation described as “competing faults”.

143. Various proposals were made for improving the text of the third redraft. A widely accepted proposal was to add in square brackets the last sentence proposed in the second redraft along the lines of “[The court may only apportion liability on an equal basis if it is unable to determine the actual apportionment or if it determines that the actual apportionment is on an equal basis].” It was widely felt that further discussion could be based on that text. Another proposal, intended to take into account the situation addressed in paragraph 2(ii) where the damage was not caused by actual fault was to rephrase the paragraph as follows:

“4. In case the fault of the carrier or of a person mentioned in article 14bis [or an event other than the one on which the carrier relied] has contributed to the loss, damage or delay together with concurring causes for which the carrier is not liable, the amount for which the carrier is liable, without prejudice to its right to limit liability as provided by article 18, shall be determined [by the court] in proportion to the extent to which the loss, damage or delay is attributable to such fault [or event].”

The Working Group took note of that suggestion.

144. After discussion, the Secretariat was requested to prepare a revised draft of the provision regarding concurring liabilities under draft article 14, taking into account the above views and suggestions.

## **5. Obligations of the carrier in respect of the voyage by sea (draft article 13)**

145. The text of draft article 13 as considered by the Working Group was as follows:

“Article 13. Additional obligations applicable to the voyage by sea

“1. The carrier shall be bound, before, at the beginning of, [and during] the voyage by sea, to exercise due diligence to:

“(a) Make [and keep] the ship seaworthy;

“(b) Properly man, equip and supply the ship;

“(c) Make [and keep] the holds and all other parts of the ship in which the goods are carried, including containers where supplied by the carrier, in or upon which the goods are carried fit and safe for their reception, carriage and preservation.

“[2. Notwithstanding articles 10, 11, and 13(1), the carrier may sacrifice goods when the sacrifice is reasonably made for the common safety or for the purpose of preserving other property involved in the common adventure.]”

146. By way of introduction, the Working Group was reminded that draft article 13 had undergone only editorial changes in A/CN.9/WG.III/WP.32. The Working Group commenced its examination of draft article 13 with paragraph 1. It was noted that three sets of square brackets remained in the text of this paragraph, and that removing the square brackets and retaining the text would make the carrier’s duty of due diligence for seaworthiness a continuing obligation.

147. Strong support was expressed in the Working Group that the square brackets be removed and the text be retained in order to make the carrier’s obligation of due diligence for seaworthiness a continuing obligation. The view was expressed that making this obligation a continuous one was in keeping with the modernization of the law governing the carriage of goods by sea, and with the International Safety Management code and safe shipping requirements.

148. Several drafting suggestions were made with respect to draft article 13(1). It was observed that different language had been used with respect to the duties expressed in subparagraphs (a), (b) and (c), such that (a) and (c) used the phrase “make [and keep]”, while (b) did not contain such a phrase. The concern was expressed that this could be erroneously interpreted to suggest that the obligation in subparagraph (b) to “properly man, equip and supply the ship” was not a continuing obligation. In response, it was stated that, in any event, the phrase “before, at the beginning of, [and during] the voyage” in the chapeau of draft article 13(1) was sufficient to ensure that this mistake was not made. While it was conceded that this phrase in the chapeau assisted in the interpretation of subparagraph (b) as a continuing obligation, it was suggested that the lack of the phrase “and keep” in that subparagraph could still result in an improper interpretation. Support was expressed for this view. Another drafting suggestion made was that gender-neutral language such as “crew” or “staff” could be considered instead of the phrase “man ... the ship” used in subparagraph (b).

149. Some support was expressed for the view that the text in square brackets should be deleted so as to ensure that the carrier’s obligation to keep the ship seaworthy existed only prior to and at the beginning of the voyage. It was observed that this would continue the approach taken in article III.1 of the Hague and Hague-Visby Rules, and it was suggested that this approach had worked well to date. It was suggested that making the obligation to provide a seaworthy vessel a continuing obligation would place too great a burden on the carrier, and that it would considerably alter the overall allocation of risk between the carrier and cargo interests in the draft instrument. The view was also expressed that there were practical problems associated with making the seaworthiness obligation a continuing one, since a ship could experience problems in the middle of the ocean, and it might not be possible to make it seaworthy until it put into a port of call. While it was acknowledged that practical problems could arise for the carrier if

seaworthiness was made a continuing obligation, it was observed that the duty of seaworthiness was one of due diligence rather than an absolute duty of the carrier, and the view was expressed that this would only amount to an obligation to take reasonable steps during the voyage. A preference was expressed that the standard that should apply to the carrier during the course of the voyage should be one of negligence, rather than the higher standard of due diligence.

150. It was proposed that instead of a continuing obligation, the Working Group could adopt the charter party “doctrine of stages” where a vessel must be seaworthy at the beginning of each stage of a voyage. There was some support for this proposal. However, the view was expressed that such “doctrine of stages” was already reflected in the draft instrument, since the carrier was under an obligation to provide a seaworthy ship at the beginning of each voyage of the goods, not of the vessel. The view was that, since the draft instrument applied to the contract of carriage of the goods, the carrier was under an obligation to exercise due diligence with respect to each contract of carriage. An additional suggestion made was that the carrier’s duty to “properly and carefully load, handle, stow, carry, keep, care for and discharge the goods” in draft article 11 would provide for sufficient continuing responsibility of the carrier.

151. Although there was strong support in favour of making the obligation of seaworthiness a continuing obligation, it was acknowledged that making the obligation a continuing one might be interpreted as significantly changing the allocation of risk in the draft instrument. There was general agreement that, if seaworthiness was to be a continuing obligation, an attempt should be made to rectify that balance with respect to the carrier in the Working Group’s consideration of other articles concerning the rights and interests of the carrier. One suggestion made was that this change in the carrier’s allocation of risk could be borne in mind during the Working Group’s discussion of draft article 14(3) on apportionment of liability in cases of multiple causation of damage. Concern was expressed that continuing the obligation of seaworthiness after the vessel sailed might be interpreted to continue the high degree of care appropriate when shore experts were available. It was suggested that the appropriate at-sea degree of care would be achieved by removing the error of navigation and management defence.

152. A question was raised with respect to the carrier’s obligation regarding containers, as mentioned in draft article 13(1)(c), and whether the contracts pursuant to which a carrier leased or provided containers were intended to be covered by the draft instrument. A view was expressed that the draft instrument was intended only to apply to contracts of carriage, and not to separate contracts for the lease or rental of containers. The contrary view was that the draft instrument should apply not only to the contract of carriage but also to related contracts, particularly those contracts that might be entered into for the execution of the contract of carriage. It was suggested that, without taking a stand as to whether such contracts related to the contract of carriage were covered by the draft instrument, the approach in draft article 13(1)(c) was in keeping with the position adopted in most courts that when the container was provided by the carrier, it should be qualified as part of the ship’s hold, and that the same obligation that the carrier had for the ship and the care of the holds should apply to those containers once the containers were loaded on board a ship. It was also noted that this approach was in keeping with

draft article 1(j) definition of “goods” to include any “container not supplied by or on behalf of the carrier or a performing party”.

153. After discussion, the Working Group agreed that the carrier’s obligation of due diligence in respect of seaworthiness should be a continuing one, and that all square brackets in draft article 13(1) should thus be removed, and the text in them retained. The Working Group also requested the Secretariat to make the necessary changes to subparagraph (b) to ensure that this obligation was understood to be of a continuing nature. It was also agreed that making this obligation a continuing one affected the balance of risk between the carrier and cargo interests in the draft instrument, and that care should be taken by the Working Group to bear this in mind in its consideration of the rest of the instrument.

154. The Working Group next turned its attention to draft article 13(2) of the draft instrument with respect to the carrier’s sacrifice of goods for the common safety or for the preservation of other property. Support was expressed for the view that this provision should be retained in its current form and location in the draft instrument, and that the square brackets surrounding it should be removed. It was suggested that this provision set out a necessary exception to the carrier’s general duty of care that had long been recognized and accepted. It was further suggested that the provision contained adequate safeguards for cargo interests, since any decision to sacrifice goods had to be reasonably made for the common safety or for the preservation of property. Another view was expressed that the inclusion of this provision could assist in redressing the shift in the allocation of risk that resulted from the continuing seaworthiness obligation in draft article 13(1). One refinement proposed to the wording of draft article 13(2) was that it should also refer to the protection of human life, while another refinement proposed was to make explicit a reference to imminent peril.

155. Support was also expressed for the view that draft article 13(2) should be deleted in its entirety. It was observed that that provision differed markedly from article IV.6 of the Hague and Hague-Visby Rules with respect to the disposal of dangerous goods and should not be retained. It was also suggested that the sacrifice of goods was already adequately covered by the general average provisions in chapter 17 of the draft instrument, and by the general duty of care of the carrier.

156. Concerns were expressed with respect to the interaction of draft article 13(2) with the general average provisions in chapter 17 of the draft instrument, particularly since draft article 13(2) did not refer to the preservation of the vessel or the cargo from imminent peril, which was an essential element of general average. Support was expressed for the proposal that if draft article 13(2) was retained, it should be moved to the chapter on general average, but that care should be taken not to prejudice or alter the rules on general average. Additional support was expressed for the view that the square brackets around draft article 13(2) should be maintained.

157. Given the level of support expressed for the rule, the Working Group decided to maintain draft article 13(2) in square brackets in its current location, with a view to considering at a later stage whether it should be moved to chapter 17 on general average. The Secretariat was also requested to consider drafting suggestions to include in the provision references to the preservation of human life and to the presence of imminent danger.

## 6. Liability of performing parties (draft article 15)

158. The text of draft article 15 as considered by the Working Group was as follows:

“1. [*Variant A of paragraph 1*]

A performing party is subject to the responsibilities and liabilities imposed on the carrier under this instrument, and entitled to the carrier's rights and immunities provided by this instrument (a) during the period in which it has custody of the goods; and (b) at any other time to the extent that it is participating in the performance of any of the activities contemplated by the contract of carriage.

[*Variant B of paragraph 1*]

A performing party is liable for loss resulting from loss of or damage to the goods as well as from delay in delivery, if the occurrence that caused the loss, damage or delay took place:

(a) during the period in which it has custody of the goods; or

(b) at any other time to the extent that it is participating in the performance of any of the activities contemplated by the contract of carriage provided the loss, damage or delay occurred during the performance of such activities.

The responsibilities and liabilities imposed on the carrier under this instrument and the carrier's rights and immunities provided by this instrument shall apply in respect of performing parties.

“2. If the carrier agrees to assume responsibilities other than those imposed on the carrier under this instrument, or agrees that its liability for the delay in delivery of, loss of, or damage to or in connection with the goods shall be higher than the limits imposed under articles 16(2), 24(4) and 18, a performing party shall not be bound by this agreement unless the performing party expressly agrees to accept such responsibilities or such limits.

“3. Subject to paragraph 5, the carrier shall be responsible for the acts and omissions of

(a) any performing party, and

(b) any other person, including a performing party's subcontractors and agents, who performs or undertakes to perform any of the carrier's responsibilities under the contract of carriage, to the extent that the person acts, either directly or indirectly, at the carrier's request or under the carrier's supervision or control, as if such acts or omissions were its own. The carrier is responsible under this provision only when the performing party's or other person's act or omission is within the scope of its contract, employment, or agency.

“4. Subject to paragraph 5, a performing party shall be responsible for the acts and omissions of any person to whom it has delegated the performance of any of the carrier's responsibilities under the contract of carriage, including its subcontractors, employees, and agents, as if such acts or omissions were its



own. A performing party is responsible under this provision only when the act or omission of the person concerned is within the scope of its contract, employment, or agency.

“5. If an action is brought against any person, other than the carrier, mentioned in paragraphs 3 and 4, that person is entitled to the benefit of the defences and limitations of liability available to the carrier under this instrument if it proves that it acted within the scope of its contract, employment, or agency.

“6. If more than one person is liable for the loss of, damage to, or delay in delivery of the goods, their liability is joint and several but only up to the limits provided for in articles 16, 24 and 18.

“7. Without prejudice to article 19, the aggregate liability of all such persons shall not exceed the overall limits of liability under this instrument.”

(a) *General discussion*

159. The Working Group was reminded of its discussion with respect to the definition of a “maritime performing party” (see above, paras. 23 to 33). The Working Group was generally in agreement with a suggestion that was made to the effect of limiting the scope of draft article 15 to such “maritime performing parties”. The consequences of such a limitation would be that the liability of non-maritime performing parties would be covered by domestic and international law applicable outside the draft instrument. In that context, it was also agreed that adjustment should be made to the title of the draft article to reflect that decision. However, the Working Group generally felt that the general policy regarding the scope of draft article 15 might need to be reviewed in respect of each of the individual paragraphs of the draft article. It was felt that the scope of paragraph (3), in particular, should extend to all performing parties, without limitation to “maritime performing parties” (for continuation of that discussion, see below, para. 166).

160. A concern was expressed that, where the contracting carrier was liable under the draft instrument and a non-maritime performing party would be subject to liabilities under another legal regime, the claimant could seek compensation under the two regimes in addition to one another. It was suggested that a rule on aggregation of claims should also apply to all performing parties. It was stated in response that applicable law outside the draft instrument would typically provide mechanisms through which double compensation could be avoided.

(b) *Paragraph (1)*

161. The Working Group reaffirmed its understanding that the draft instrument should, in principle, avoid dealing with non-maritime performing parties and that the scope of paragraph (1) should be restricted to maritime performing parties.

162. Broad support was expressed in favour of Variant A. It was suggested that an improvement to the text would result from inserting the words: “if the occurrence that caused the loss, damage or delay took place” before the text of subparagraph (a) in Variant A. That suggestion was found acceptable by the Working Group. A second suggestion was made to add words along the lines of “to the extent that it is established by the claimant” before the other phrase suggested for insertion. It was

stated in response that the purpose of paragraph (1) was not to deal specifically with burdens of proof but to place the maritime performing party on an equal footing with the contracting carrier, including the rules applicable to such contracting carrier in respect of burdens of proof. The second suggestion was not adopted by the Working Group.

(c) *Paragraph (2)*

163. The Working Group generally agreed with the substance of the paragraph. It was also agreed that the scope of paragraph (2) should be restricted to maritime performing parties. In response to a proposal that the word “higher” should be replaced by the word “different” to allow the parties to agree to a lower limit of liability, it was pointed out that the contracting carrier should not be allowed to contract with the shipper to the detriment of the performing party (or of any other third party). It was acknowledged that the liability of the performing party could be reduced by agreement but not as a result of a contract to which it was not a party. The proposal was withdrawn by its proponents.

164. Another proposal was made to replace the words “unless the performing party expressly agrees to accept such responsibilities or such limits” by wording along the lines of “unless the performing party has knowledge of such responsibilities or such limits”. That proposal was objected to on the grounds that a contract should not bind a third party unless that third party had at least accepted to be bound. Simple knowledge of a contract by a third party should not result in that third party being bound.

165. Yet another proposal was made to limit the reference to draft article 18. It was stated that, while the reference to paragraphs (1), (3) and (4) of draft article 18 was acceptable, paragraph (2) of draft article 18 should not be referred to since the performing party was not liable in case of non-localized damage. The Working Group took note of the suggestion and decided that it might need to be further discussed after a decision had been made regarding the inclusion of paragraph (2) of draft article 18 in the draft instrument.

(d) *Paragraph (3)*

166. There was general agreement that, in view of the decision that the contracting carrier should be liable under the draft instrument for all its subcontractors, agents or employees, paragraph (3) should apply to both maritime and non-maritime performing parties, and possibly also to persons that would not fall under the definition of “performing party”. The attention of the Working Group was drawn to the fact that the definition of “performing party” (see above, paras. 34 to 42) already encompassed all subcontractors of the performing party.

167. The question of the placement of paragraph (3) was raised. Although support was expressed in favour of maintaining paragraph (3) within draft article 15 in view of the close relationship between the various paragraphs in that draft article, the prevailing view was that a provision dealing with the liability of the carrier did not fit well in an article dealing with the liability of maritime performing parties. It was agreed that paragraph (3) should become a separate article, provisionally numbered draft article 14 bis.

168. Various suggestions were made regarding the substance of paragraph (3). One suggestion was that the contents of paragraph (3) should mirror that of

paragraph (4). In that respect, it was pointed out that an express reference to the “employees” of the contracting carrier should be added in subparagraph (b), since the reference to “any other person” was insufficiently clear and a reference to the scope of that person’s “employment” was already included in the second sentence of the subparagraph. That suggestion was accepted by the Working Group. As a matter of drafting, it was pointed out that further consideration might need to be given to the possibility of dealing separately with employees (for whom the contracting carrier’s liability should be very broad) and with subcontractors (in respect of whom the liability of the contracting carrier might be somewhat narrower).

169. Another suggestion was that the words “who performs or undertakes to perform” should be replaced by the words “who physically performs or undertakes to perform”. That suggestion was objected to on the grounds that the contracting carrier should never be allowed to delegate liability, whether he delegated physical or other type of performance.

170. It was stated that the words “Subject to paragraph 5” might be inaccurate since paragraph (3) dealt with actions brought against the carrier, while paragraph (5) dealt with actions brought against any person, other than the carrier. Accordingly, it was suggested that the words “Subject to paragraph 5” should be replaced by “Subject to the liability and limitations of liability available to the carrier”. While support was expressed for that suggestion, the Working Group decided to maintain the reference to paragraph 5, subject to further discussion at a later stage.

(e) *Paragraph (4)*

171. Consistent with a suggestion made in the context of the discussion of paragraph (3), it was suggested that the situation of employees under paragraph (4) might be differentiated from that of subcontractors. For example, it was stated that the notion that performance was “delegated” might be appropriate for a subcontractor but seemed too narrow to address the situation of an employee, which might be better covered by wording along the lines of “a performing party shall be responsible for the acts and omissions of its employees, provided they acted within the scope of their employment”. Another example given was that the text of paragraph (4) should avoid suggesting that a subcontractor could delegate “any” of the obligations of the carrier, since the subcontractor could only delegate those obligations of the carrier the subcontractor had undertaken.

172. The Working Group reaffirmed its earlier decision that the structure of paragraph (4) should mirror that of paragraph (3). In that connection, a question was raised as to whether the scope of paragraph (4) should be extended to cover both maritime and non-maritime performing parties. After discussion, it was recalled that the provision that would replace paragraph (3) as a separate article should establish the liability of the contracting carrier also in respect of subcontractors and employees of its subcontractors. That provision was intended to establish a general liability of the contracting carrier for all conceivable agents or subcontractors the contracting carrier might rely upon. However, since paragraph (4) dealt with employees and subcontractors from the perspective of the maritime performing party and not from that of the contracting carrier, there was no need to extend the scope of paragraph (4) to non-maritime performing parties. While the Working Group was generally in agreement with the difference in scope between

paragraphs (3) and (4), the recurring view was expressed that the maritime subcontractor dealt with under paragraph (4) should still be responsible for all of its subcontractors, whether maritime or non-maritime. The view was also reiterated that paragraph (4) should mirror the general rule in paragraph (3) since in both provisions, the contracting carrier and the maritime performing party were placed in parallel situations vis-à-vis their maritime and non-maritime subcontractors. It was pointed out that those views were not in conflict with the general policy that the non-maritime performing party, as such, should not be regulated under the draft instrument. The Working Group took note of those views for continuation of the discussion at a future session.

(f) *Paragraph (5)*

173. It was suggested that the reference to paragraph (3) should be deleted to avoid any interpretation extending the protection of “Himalaya clauses” to non-maritime performing parties. While the Working Group generally approved the intended result of that suggestion, it was observed that the deletion of the reference to the persons mentioned in paragraph (3) would deprive employees and agents of the carrier of the benefit of “Himalaya clauses”. A revised suggestion was that paragraph (5) might need to list expressly those persons mentioned in paragraph (3) to which the benefit of such clauses should extend. In the context of that discussion, the view was expressed that since, historically, “Himalaya clauses” had been introduced for the protection of employees, the scope of paragraph (5) should be restricted to such employees of the carrier, to the exclusion of subcontractors of the carrier. The view was also expressed that the benefit of “Himalaya clauses” should only extend to those parties who were liable under the draft instrument. An alternative suggestion was made for a restriction of the scope of paragraph (5) to employees of the contracting carrier or of a maritime performing party, if they proved that they had acted within the scope of their employment.

174. In response to those suggestions, it was pointed out that a clear departure from the interpretation of the Hague and Hague-Visby Rules might adversely affect the acceptability of the draft instrument. It was also pointed out that the definition of “performing party” covered only those persons that “physically” handled the goods. Therefore, pilots, cargo inspectors and other persons that might assist the carrier would not be protected by “Himalaya clauses”. As to the formulation of the draft instrument, it was suggested that the protection created by paragraph (5) should be extended at least to “employees or agents of the contracting carrier or of a maritime performing party”. An alternative suggestion was that wording should be introduced to extend such protection to all the parties involved in the maritime operations, including independent subcontractors.

175. After discussion, the Working Group agreed that, as an alternative to the existing text of paragraph (5), the words “employees or agents of the contracting carrier or of a maritime performing party” should be inserted in square brackets for continuation of the discussion at a future session. The Secretariat was requested to examine the possibility of introducing a further variant limiting the scope of paragraph (5) to the maritime sphere.

176. As a matter of drafting, it was suggested that the words “Any action” might lend themselves to misinterpretation and should be replaced by the words “Any action under this instrument”. The Working Group took note of that suggestion.

(g) *Paragraph (6)*

177. Concerns were expressed with respect to the translation of the legal notion of “joint and several liability” in a number of official languages. It was pointed out that, for example, in French and Spanish, the phrases “*responsabilité solidaire*” and “*responsabilidad solidaria*” respectively, should be used. The Working Group requested the Secretariat to ensure that the notion was used consistently in all official languages. A suggestion was made to introduce a definition of “joint and several liability” in the draft instrument. However, it was generally felt that such a definition might be superfluous to the extent that corresponding concepts existed in the various legal systems. It was further suggested that the provisions of paragraph 6 should not prevent parties that are liable from resorting to recourse actions.

178. Regarding the substance of paragraph (6), a question was raised as to how the reference to “the limits provided for in articles 16, 24 and 18” would interplay with the operation of the international conventions referred to in draft article 8 that might be applicable before or after the sea leg of the carriage. In response, it was pointed out that, in relation to maritime performing parties, draft article 8 would not apply. Furthermore, while draft article 8 might apply in relation to non-maritime performing parties, there seemed to be no example of a single situation where a claimant would have an option to sue a contracting carrier or a non-maritime performing party to whom article 8 might be applicable. It was stated that concurring actions were only conceivable in actions against the contracting carrier or against a maritime performing party, both of whom would be covered by maritime limitations.

179. A concern was expressed with respect to the operation of limits of liability. In a situation where two parties were liable but the limit of liability did not apply in respect of only one of those parties, the theory of joint and several liability would apply up to the limit in respect of one party but the other party should be liable beyond the limit. In order to clarify that paragraph 6 should only deal with maritime performing parties and in response to that concern, a suggestion was made to simplify the text of paragraph (6) along the following lines: “The contracting carrier and the maritime performing party are jointly and severally liable.” It was suggested that the issue should be further discussed in the context of paragraph (7).

180. After discussion, the Working Group agreed that the scope of paragraph (6) should be limited to maritime performing parties.

181. Due to the absence of sufficient time, the Working Group did not discuss paragraph (7) of draft article 15.

#### **IV. Other business**

182. The Working Group noted that its thirteenth session was scheduled to be held in New York from 3 to 14 May 2004. The Working Group took note with appreciation of the decision made by the Commission at its thirty-sixth session that two-week sessions would be allocated to the Working Group for continuation of its work (see A/58/17, para. 275).

183. The Working Group took note of an initiative by some delegations to organize a seminar on issues of freedom of contract in door-to-door international carriage of goods wholly or partly by sea before the thirteenth session of the Working Group. The Secretariat was requested to examine the possibility of co-sponsoring the seminar.

**B. Working paper on the preparation of a draft instrument on the carriage of goods  
[by sea]: addendum to compilation of replies to a questionnaire on door-to-door  
transport and additional comments by States and international organizations on the  
scope of the draft instrument, submitted to the  
Working Group on Transport Law at its twelfth session  
(A/CN.9/WG.III/WP.28/Add.1) [Original: English/Spanish]**

ADDENDUM

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### Introduction

1. In January 2003, a document entitled “Compilation of replies to a questionnaire on door-to-door transport and additional comments by States and international organizations on the scope of the draft instrument” was published (A/CN.9/WGIII/WP.28). That document consisted of responses to a questionnaire circulated to interested non-governmental and inter-governmental organizations, as well as to States, in August 2002, and was intended to gather information regarding the practice of containerized transport and the use of door-to-door contracts by carriers. Included in that document were additional statements and contributions submitted to the Secretariat in connection with the preparation of the draft instrument. This document consists of responses and statements received by the Secretariat after the date of publication of the original compilation. Again, the questionnaire is reproduced as an annex to this note.

2. A set of responses to the questionnaire received from a non-governmental organization is reproduced in section I below.

3. Additional statements and contributions submitted to the Secretariat by non-governmental

organizations in connection with the preparation of the draft instrument are reproduced in section II below.

4. The responses, statements and contributions referred to in paragraphs 2 and 3 above are reproduced in the form in which they were received by the Secretariat.

## I. Replies to the questionnaire from non-governmental organizations

### Ibero-American Maritime Law Institute

[Original: Spanish]

1 and 2. To have a uniform liability scheme for door-to-door transport covering the overseas leg would undoubtedly be useful for all concerned with international trade. The critical question is what the uniform rules will be based on and to what extent they can be incorporated in national and regional legal systems that contain rules relating to the different modes of transport—in some cases, public policy norms. By way of example, we would mention Cartagena Agreement Decisions 331 and 393 and the Agreement on International Multimodal Transport between the States Parties of MERCOSUR.

In the draft instrument that we are concerned with, it will be a question of implementing a *particular* regime for multimodal transport, already regulated—in general terms—in the 1980 United Nations Convention on International Multimodal Transport of Goods.

A “particular” liability regime might give rise to problems to the extent that it differs from the solution adopted in the 1980 Convention. That would be particularly so if the liability system were to diverge from the Hamburg Rules, which are in force and constitute the source of the 1980 Multimodal Convention.

3. The idea of assimilating land transport to sea transport is in conflict with the fact that the practices and applicable procedures differ in nearly all countries. This reflects the historical recognition that maritime transport is of a particular nature and subject to special risks, particularly the so-called “perils of the sea”. This recognition led long ago to the acceptance of a limitation of liability and the concept of “accidents at sea”. The provisions on exoneration from and limitation of liability contained in the Hague-Visby Rules would not seem to correspond to the *needs of the industry*, as they did more than half a century ago. The new trend in so-called “damages law” is in the direction of objective liability and complete compensation for damage caused. These new concepts must be taken into account, particularly where they apply to the transport of goods by land in many countries.

4. The ideal of a uniform system as mentioned above, comes into conflict with the different ontological and legal realities involving stevedoring companies, land carriers, warehouses, terminals, etc. The differences arise, *inter alia*, in the liability systems, the grounds for exoneration, the limitation of liability and the time limits for actions.

5. In the case of multimodal transport, one could allow for proceedings by the damaged party against the responsible party (localized damage) or any of those participating in the transport chain, on the assumption of joint and several liability—without prejudice to the right of the defendant to recover any compensation paid from the party actually responsible for the damage.



The argument in favour of this principle is the existence of a common, shared interest between the multimodal transport operator (MTO) and the successive carriers and among all these, together with the concept of multimodal transport as based on an underlying, indivisible, collective contract with a number of obligated parties, the parties being jointly answerable for the complete transport operation; the contractual relationship is formalized not initially but successively, each carrier acceding to the contract upon receiving the goods. The joint liability derives from the existence of a shared, common interest, particularly as joint and several liability is assumed in commercial matters. The principle is further justified by the disadvantageous position of the shipper with regard to identifying who is responsible for loss, damage or delay in the delivery of the goods. This problem arises continually in the transport of goods consolidated in containers.

6. This question refers to the application of a convention covering road transport, such as the Convention on the International Carriage of Goods by Road, applicable in Europe and not affecting the Ibero-American countries. The question would therefore have to be answered by countries that apply this regime and have adopted common solutions for land transport in a regional context. Purely theoretically, it might be supposed that there should be no difference between the liability system applying to sea and land, provided that the uniform system adopted contains common characteristics relating to the guarantee obligation assumed by the MTO towards the shipper.

7. Following up the above reply, a uniform liability regime could be beneficial as helping to improve legal certainty. Some authors add an economic factor relating to transport cost. However, this would have to be demonstrated in detail.

8. The differences in the liability systems for the different modes of transport involved in a door-to-door contract lead to: (a) uncertainty regarding legal proceedings in respect of damaged goods and regarding the conditions for safeguarding the claimant's rights; (b) differences in the amount of compensation (complete or limited); (c) differences in the "burden of proof" depending on the mode of transport or the place where the damage occurred; (d) uncertainty affecting the claim when the place or origin of the damage in the transport chain is not known; (e) the possible responsibility of the forwarder when the transport was not contracted for by the shipper. In this situation, consideration should also be given to the case of goods of various shippers being consolidated by the same forwarder and covered by a single transport document.

9. The possibility of direct claims against those responsible for damage in the case of subcontractors is in line with the principle of joint liability discussed above (reply 5).

10. Comments on the draft have been made in the sessions of the Working Group. Those comments are still valid. The scientific contribution made by the drafters is very valuable and important, leaving aside the question of the appropriate scope of application for the instrument—it is suggested that it should establish a "port-to-port" regime. The creation of a "particular" regime for multimodal transport (with a maritime leg) does not harmonize with the existence of a general regime for multimodal transport. On the other hand, useful progress has been made in the drafting of uniform regulations for certain aspects ignored in earlier sets of rules concerning transport (for example, with regard to electronic records, performing party, right of control, etc.).

In general, at the present stage of universal legislation (including the Latin American regional framework), given the differences between the liability systems for land carriers, including the liability of terminals, it would not seem opportune or desirable to extend the solutions governing the liability of the carrier under maritime law to the land legs of door-to-door transport.

## **II. Additional statements and contributions received from non-governmental organizations in connection with the preparation of the draft instrument**

### **1. International MultiModal Transport Association (IMMTA)**

[Original: English]

IMMTA is of the opinion that the present transport liability regimes are outdated, severely fragmented, and costly for their users, and that a better system would be highly desirable.

A new global approach that would cover all modes of transport in a common manner would be highly desirable. If it were possible to submerge all modes of transport into a single global regime, that would be an approach that might find favour among many of the transport users and providers. IMMTA is therefore of the opinion that this would be a desirable goal.

Should this prove to be too radical a shift in the way in which transport regimes may be modernized, then an alternative would be to work towards achieving coherence at least in the movement of goods from door to door regardless of the individual modes being used. However, this must not be a maritime convention extended beyond the port, but a true multimodal instrument. If this is not the case it will surely fail. For example, concerns of railways must be taken fully into account.

IMMTA strongly believes that the elaboration of any such new door-to-door liability regime must be undertaken with representatives from all interested modes and users participating in the work. Any work that is undertaken without full participation by all those parties will only produce yet another unworkable instrument that will fail to remedy the current unsatisfactory situation.

Any such new international liability regime would have to offer clear advantages as compared with the existing legal framework in order to succeed. Any measure that would turn out to be of a stop-gap nature would only add to the current complexity without providing any benefits.

Any new instrument would have to employ well-known language in order to be immediately comprehensible for transport courts. This would mean borrowing language from existing transport conventions to the largest possible extent. If there is a desire to modernize the language used in those conventions that were adopted at the beginning of the 20<sup>th</sup> century, then the drafters should look to those conventions that have been elaborated in the second half of the 20<sup>th</sup> century for guidance. Guidance might also be sought from the draft US COGSA text. In this connection the drafters must take great care in making the text clear and unconfusing.

The present draft text covers areas that lie outside existing conventions and the Working Group should therefore consider with great care the benefits of including those areas in a new instrument.

## 2. International Union of Marine Insurance (IUMI)

[Original: English]

The International Union of Marine Insurance (IUMI) was founded in 1874. It represents 53 national marine insurance associations from markets all over the world. IUMI members cover 80 per cent of the world premium in marine insurance totalling approximately USD 10.5 billion (2001).

As an international organisation representing insurers of both carriers and cargo interests, IUMI supports the creation of a modern uniform treaty for the carriage of goods by sea that would be fair, balanced and reasonable for all parties involved.

IUMI welcomes the initiative by UNCITRAL to promote the cause of harmonisation of international maritime law and greatly appreciates the contributions of CMI in preparing the Draft Instrument.

IUMI is pleased to respond to UNCITRAL' s invitation to commercial parties to participate in the creation of a modern Instrument and submits the following:

### **Scope of Application (Draft Article 4.2.1)**

IUMI believes that the draft instrument should be extended to “door to door” shipments that involve an overseas leg. Such a clear legal framework would result in less disputes and simpler recovery proceedings because one of the major difficulties under the current system is establishing where the loss or damage took place and, consequently, which carrier is liable and which liability regime applies. Additionally, it can be difficult to identify the carrier and foreign jurisdiction clauses may pose problems. The ideal solution would be to have a uniform set of rules applicable throughout the carriage, rather than a network system, even if limited in scope, because the network system creates uncertainty. Easy access to recovery, a better understanding of the carrier’s liability and less paper work would be the result. To achieve this, we first need the support from the organizations representing all participants involved with the shipments, such as stevedores, terminal operators, truckers, railroads, and warehouse keepers.

However, domestic issues regarding jurisdiction may occur and international acceptance is not yet uniform. If a uniform system of liability cannot be achieved because of the existing international conventions governing single modes of transport, IUMI would like to see liability limits on the non-localized damages to be governed by the higher international mandatory provisions.

### **Performing Parties (Draft Article 1.17)**

IUMI is strongly in favour of allowing direct claims against sub-contractors and would support a rule imposing joint and several liability on the contracting carrier and the actual carrier as well as against any intermediate carrier or forwarder sub-contracting the transport to another carrier. IUMI will emphasise that in this respect it is of great importance that the rules of the Convention be clear and unambiguous as to whether any intermediate carrier or forwarder may be sued. Under the CMR Convention the solution on this point seems to be left to the courts of each country. Such uncertainty must be avoided.

### **Liability of Carriers (Draft Article 4,5, 6)**

IUMI believes that the present risk allocation should be modified. IUMI is in favour of eliminating the error in navigation or management defense. No statistical records are available

to evaluate the reduction of cargo insurers risks, but underwriters estimate that the reduction of risk would be less than 4 %.

IUMI believes that the fire exemption should be deleted. No statistical records are available to evaluate the reduction of cargo insurers risks, but estimation is that it would be less than 2 %.

IUMI is also in favour of extending the seaworthiness obligation to the whole sea voyage. No statistical records are available to evaluate the reduction of cargo insurers risks, but estimation is that it would be less than 1 %.

#### **Article 6.1.4 of the Draft Instrument**

IUMI supports maintaining the present system of carrier liability for the entire loss except to the extent the carrier can prove that the loss was caused by an event for which it is not liable. Requiring the carrier and the claiming party to share the burden of proving the cause of the loss is impractical, since it implies that cargo has the same access to information concerning transit conditions and cargo handling performance as the carrier. This is patently not the case. IUMI estimation of the increase of cargo insurers risk, if the division of 50/50 of the loss would be applied, is over 10 %.

#### **Mixed Contract of Carriage and Forwarding (Draft article 4.3)**

IUMI is strongly opposed to the possibility of the carrier being able to contract out of the regime by adopting a role of agent only.

The carrier should not be allowed to change its role from principal to agent during the course of a voyage. In practice, it would be extremely difficult, if not impossible, to ascertain in which capacity the carrier was acting at different stages of the voyage. To allow a carrier to act as both an agent and principal during the course of a voyage will encourage strategic legal barriers and promote practices designed principally to avoid liability to save costs.

As drafted, the provision requires “express agreement” which, in many jurisdictions, might be satisfied by “boilerplate” pre-printed clauses. The carrier should not be allowed to reduce his role to that of an agent and to be relieved of the carrier’s liability on the basis of “boilerplate” language on the transport document.

In liner trades, cargo owners do not have control over who the carrier contracts with for services, and to bring legal suit in an overseas jurisdiction following an expensive investigation into cause will be a major disincentive to pursue genuinely recoverable claims.

#### **Notice of Loss (Draft article 6.9)**

The proposed three-day time limit is not adequate and is in most cases impossible to meet in practice. This notice period was set a century ago at a time when cargo was less complex, damage was more obvious, and cargo handling at destination much less automated.

IUMI believes that a seven-day notice period would be reasonable for all shipments, whether door-to-door or port-to-port, because it would give consignees a realistic opportunity to inspect the goods. There is an increased volume of trade, and more security, inspection and reporting requirements for consignees after delivery. In some cases this may lead to an earlier identification of damage, but other priorities may delay notification to a carrier, such as automated inventory management systems and food safety testing.

**Time for Suit (Draft article 14.1)**

This is a matter of fundamental practical significance for cargo insurers. The short time limitation of one year causes unnecessary litigation in order to protect claims from being time barred.

While it is not possible to estimate the cost for unnecessary litigation and extra personnel accurately, legal proceedings can be in excess of 10% of the recovery claim amount. This litigation cost would be greatly reduced if the limitation period would be extended. IUMI believes that the period should be two years, the same as adopted in conventions such as the Hamburg Rules, the recently adapted Budapest Convention on Contracts for the Carriage of Goods by Inland Waterways 2000, and the Montreal Convention of 1999.

If the one-year time limitation is not extended, the limitation period should be tolled while the carrier is considering the claim. Consignees are obliged to give preliminary notice within a limited time following delivery. The carrier has the right to inspect the cargo at that time. It is always fairly self-evident that a recovery claim will ensue. Cargo interests have the obligation at the time of presenting their recovery claim to show that salvage - which can be protracted over a period of time, particularly if refining or remanufacturing is involved - has been effectively conducted. Best practice dictates that the most efficient method is to keep the carrier informed and involved throughout this process (e.g., by inviting comment or re-inspection). In addition, obtaining information from the carriers takes time, if it is made available at all, for which cargo should not be penalised. Investigations into cause can also be lengthy, particularly in jurisdictions where maritime safety authorities and/or the courts themselves investigate casualties and take some time in publishing their findings.

In addition, it is crucial that an extension of time is obtained on behalf of the proper parties and from the proper parties. This is often a complicated legal matter requiring the assistance of legal experts and time-consuming investigations in order to identify who has title to sue, and who is liable under the contract of carriage.

We see little purpose in maintaining the one-year time bar, as it does not save any costs for carriers and can result in an arbitrarily short time bar to genuinely complex cargo claims. Further, the present system seems quite unfair as it rewards carriers that unnecessarily delay in handling a claim.

**Limits of Contractual Freedom and Scope of application (Draft Articles 3 and 17)**

Obviously, allowing parties to contract out of the Draft Instrument's provisions would reduce the uniformity of the regime. Thus, IUMI believes that there should be limited ability to contract out.

Contracting parties should not be entitled to contract out of the provisions. Under the Hague and Hague-Visby rules, parties may contract out of the provisions in the case of special agreements, under non-negotiable receipts, and where the subject of the agreement justifies special arrangements and is not an "ordinary commercial shipment" made in the "ordinary course of trade". We believe that this position should be maintained in the Draft Instrument.

Additionally, third parties should not be bound if the parties to an agreement are allowed to contract out of the Draft Instrument's provisions.

However, the provisions on charter parties, space and slot charters, and transport of live animals should not necessarily be mandatory.

### Forum

Some serious concern has been expressed by some members of IUMI regarding the possible forum provision for litigation and arbitration of disputes. IUMI urges adoption of the language contained in the Hamburg Rules, in which claimants may select a forum from a list of options, including the place where the shipment originates or the place of delivery. The contracting carrier and the shipper should not be allowed to agree on a forum and impose that selection on a consignee that has not agreed.

### ANNEX

#### QUESTIONNAIRE

1. Do you feel that it would be helpful to have a single liability scheme applicable to door-to-door shipments which involve an overseas leg?
2. If so, why?
3. Should the same law be applicable to the entire transport of the goods, both on land and sea?
4. Should all of the participants in the door-to-door carriage of the cargo, including stevedores, terminal operators, truckers, railroad, warehouses and others, be subject to the same liability regime as the ocean carrier?
5. Should the participants in door-to-door carriage, such as the stevedores, terminal operators, truckers, railroads, warehouse and others be subject to direct claims by cargo interests or their underwriters under a single multi-modal regime for damage caused by the particular participant?
6. In the event that existing conventions apply to land transport, such as the Convention on the International Carriage of Goods by Road (CMR), should those conventions continue to control the liability of the land carrier when the land carrier is involved in the carriage of goods over sea and land, or could the land carrier under certain circumstances be subject to the same liability regime as the ocean carrier?
7. What advantages, if any, do you see in applying a uniform liability regime to both land and sea transport in multi-modal carriage?
8. What problems are commonly experienced today, if any, as a result of the existing system of liability regimes for door-to-door carriage of goods?
9. Do you perceive any advantages to the industry if cargo interests or their underwriters are given the opportunity to make a claim directly against the subcontractor of the carrier who issues the bill of lading for damage or loss that occurred whilst in the subcontractor's custody?
10. Please take this opportunity to indicate if you have any further comments or observations in respect to the instrument as currently drafted by UNCITRAL.

**C. Note by the Secretariat on the draft instrument on the carriage of goods  
[wholly or partly] [by sea], working paper submitted to the Working Group  
on Transport Law at its twelfth session**

**(A/CN.9/WG.III/WP.32) [Original: English]**

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## Introduction

1. At its thirty-fourth session, in 2001, the Commission established Working Group III (Transport Law) and entrusted it with the task of preparing, in close cooperation with interested international organizations, a legislative instrument on issues relating to the international carriage of goods such as the scope of application, the period of responsibility of the carrier, obligations of the carrier, liability of the carrier, obligations of the shipper and transport documents.<sup>i</sup> At its thirty-fifth session, in 2002, the Commission approved the working assumption that the draft instrument on transport law should cover door-to-door transport operations, subject to further consideration of the scope of application of the draft instrument after the Working Group had considered the substantive provisions of the draft instrument and come to a more complete understanding of their functioning in a door-to-door context.<sup>ii</sup>
2. At its thirty-sixth session, in July 2003, the Commission had before it the reports of the tenth (Vienna, 16-20 September 2002) and eleventh (New York, 24 March-4 April 2003) sessions of the Working Group (A/CN.9/525 and A/CN.9/526, respectively).
3. The Commission was mindful of the magnitude of the project undertaken by the Working Group and expressed appreciation for the progress accomplished so far. It was widely felt that, having recently completed its first reading of the draft instrument on transport law, the Working Group had reached a particularly difficult phase of its work. The Commission noted that a considerable number of controversial issues remained open for discussion regarding the scope and the individual provisions of the draft instrument. Further progress would require a delicate balance being struck between the various conflicting interests at stake. A view was stated that a door-to-door instrument might be achieved by a compromise based on uniform liability, choice of forum and negotiated contracts, which would not deal with actions against performing inland parties. It was also stated that involving inland road and rail interests was critical to achieve the objectives of the text. A view was expressed that increased flexibility in the design of the proposed instrument should continue to be explored by the Working Group to allow for States to opt-in to all or part of the door-to-door regime.
4. The Commission also noted that, in view of the complexities involved in the preparation of the draft instrument, the Working Group had met at its eleventh session for a duration of two weeks, thus making use of additional conference time that had been made available by Working Group I completing its work on privately financed infrastructure projects at its fifth session, in September 2002. The Chairman of Working Group III confirmed that, if progress on the preparation of the draft instrument was to be made within an acceptable time frame, the Working Group would need to continue holding two-week sessions. After discussion, the Commission authorized Working Group III, on an exceptional basis, to hold its twelfth and thirteenth sessions on the basis of two-week sessions. It was agreed that the situation of the Working Group in that respect would need to be reassessed at the thirty-seventh session of the Commission in 2004. The Working Group was invited to make every effort to complete its work expeditiously and, for that purpose, to use every possibility of holding inter-session consultations, possibly through electronic mail. The Commission realized, however, that the number of issues open for

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discussion and the need to discuss many of them simultaneously made it particularly relevant to hold full-scale meetings of the Working Group.<sup>iii</sup>

5. The annex to this note contains revised provisions for a draft instrument on the carriage of goods [wholly or partly] [by sea] prepared by the Secretariat for consideration by the Working Group. Changes to the text previously considered by the Working Group (contained in document A/CN.9/WG.III/WP.21) have been indicated by underlining and strikeout.

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<sup>i</sup> *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 and corrigendum (A/56/17 and Corr.3), para. 345.*

<sup>ii</sup> *Ibid., Fifty-seventh Session, Supplement No. 17 (A/57/17), para. 224.*

<sup>iii</sup> *Ibid., Fifty-eighth Session, Supplement No. 17 (A/58/17), paras. 205-208.*

## Annex

# Draft instrument on the carriage of goods [wholly or partly] [by sea]

## CHAPTER 1. GENERAL PROVISIONS

### Article 1. Definitions<sup>1</sup>

For the purposes of this instrument:

~~(a)1.5~~ “Contract of carriage”<sup>2</sup> means a contract under which a carrier, against payment of freight, undertakes to carry goods **wholly or partly**<sup>3</sup> by sea from one place to another.

~~(b)1.4~~ “Carrier”<sup>4</sup> means a person that enters into a contract of carriage with a shipper.

~~(c)1.3~~ “Consignor”<sup>5</sup> means a person that delivers the goods to ~~a~~ the carrier or a performing party<sup>6</sup> for carriage.

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<sup>1</sup> Paragraph 72 of the Report of the 9<sup>th</sup> session of the Working Group on Transport Law (A/CN.9/510) noted that it was generally agreed that the readability of the draft instrument would be improved if the definitions were arranged according to a more logical structure by first listing the various parties that might intervene in the contractual relationships covered by the draft instrument and then listing the technical terms used in the draft provisions. The order of the definitions has been changed as suggested. The Working Group may also wish to consider titles for those articles in the draft instrument that do not currently have them.

<sup>2</sup> It was suggested in paragraph 83 of A/CN.9/510 that this definition was too simplistic and might require a more detailed consideration of the various obligations of the carrier. It was further suggested that the shipper also be mentioned, and that the definition should refer to a “person” rather than to a “carrier”. No decisions were made on these matters, and the suggestions have not, therefore, been incorporated.

<sup>3</sup> It is noted in paragraph 85 of A/CN.9/510 that the Working Group decided that the words “wholly or partly” would be maintained in the draft provision, but that the words “wholly or partly” would be identified by adequate typographical means as one element of the draft instrument that might require particular consideration in line with the final decision to be made regarding the scope of the draft instrument. The Working Group may also wish to consider whether the phrase “wholly or partly” should appear in the title of the draft instrument.

<sup>4</sup> It was recalled in paragraph 73 of A/CN.9/510 that this definition followed the same principle as the Hague-Visby and Hamburg Rules. Concern was expressed that the definition did not make sufficient reference to parties on whose behalf a contract was made, nor did it adequately cover the case of freight forwarders, nor did it make clear that it intended to cover both legal and natural persons. No agreement was reached on these issues, but it was agreed in paragraph 74 of A/CN.9/510 that the current definition constituted an acceptable basis for continuation of the discussion.

<sup>5</sup> Support was expressed in paragraph 78 of A/CN.9/510 for the introduction of a mention that the consignor delivered the goods “on behalf” of the shipper. It was also suggested in paragraph 79 of A/CN.9/510 that additional language should be introduced to clarify that the consignor should deliver the goods to the “actual” or “performing” carrier, but the view was expressed that the words “a carrier” sufficiently addressed the possibility that a performing party might intervene in addition to the original carrier. Finally, a view was expressed in paragraph 80 of A/CN.9/510 that the Working Group might consider the text of article 1, paragraph 5 of the Multimodal Convention in revising the definition. The Working Group did not reach any agreement with respect to revising this provision.

~~(d)1.19~~ “Shipper”<sup>7</sup> means a person that enters into a contract of carriage with a carrier.

~~(e)1.17~~ “Performing party”<sup>8</sup> means a person other than the carrier that physically performs ~~[or undertakes to perform]~~ ~~[or fails to perform in whole or in part]~~<sup>10</sup> any of the carrier’s responsibilities under a contract of carriage for the carriage, handling, custody, or storage of the goods, to the extent that that person acts, either directly or indirectly, at the carrier’s request or under the carrier’s supervision or control, regardless of whether that person is a party to, identified in, or has legal responsibility under the contract of carriage. The term “performing party” does not include any person who is retained by a shipper or consignee, or is an employee, agent, contractor, or subcontractor of a person (other than the carrier) who is retained by a shipper or consignee.

~~(f)1.12~~ “Holder”<sup>11</sup> means a person that ~~(a)~~ is for the time being in possession of a negotiable transport document or has the exclusive [access to] [control of] a negotiable electronic record, and ~~(b)~~ either:

(i) if the document is an order document, is identified in it as the shipper or the consignee, or is the person to whom the document is duly endorsed, or

(ii) if the document is a blank endorsed order document or bearer document, is the bearer thereof, or

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<sup>6</sup> An oversight was carried over from the original draft of the instrument from CMI, which had intended to correct the phrase “a carrier” to read “the carrier or a performing party” in those situations where such a change was necessary. This adjustment has been made at various points in this iteration of the draft instrument.

<sup>7</sup> As noted in paragraph 107 of A/CN.9/510, bearing in mind the concerns expressed in the context of the definition of “carrier” in paragraph 1.1 (now paragraph (b)), it was generally agreed that the draft definition of “shipper” constituted an acceptable basis for continuation of the discussion at a future session.

<sup>8</sup> While some views were expressed to the contrary, it is noted in paragraph 99 of A/CN.9/510 that wide support was expressed for the presence of this notion in the draft instrument; its concept was also widely supported, including the use of the term “physically performs” as a way to limit the categories of persons to be included within the definition. As noted in paragraph 104 of A/CN.9/510, suggestions were made to simplify and shorten the drafting of the definition, and it was suggested to delete the words “regardless of whether that person is a party to, identified in, or has legal responsibility under the contract of carriage” as unclear and as adding nothing substantial to the definition. However, it is unclear whether this suggestion received sufficient support in the Working Group.

<sup>9</sup> As noted in paragraph 100 of A/CN.9/510, it was suggested that all of the options for the definition of “performing party” contained in the draft text and commentary should be retained for the time being. Paragraph 16 of A/CN.9/WG.III/WP.21 suggested as a possible alternative to the relatively restrictive definition represented in the original text of A/CN.9/WG.III/WP.21, a relatively inclusive definition that might be drafted with the following language at the start of the sentence: “a person other than the carrier that performs or undertakes to perform any of the carrier’s responsibilities under a contract of carriage for the carriage, handling, custody, or storage of the goods, to the extent that ...”.

<sup>10</sup> It is noted in paragraph 104 of A/CN.9/510 that the Working Group considered that these words should be deleted.

<sup>11</sup> The suggestion was made in paragraph 91 of A/CN.9/510 that the term “for the time being” was unnecessary, and support was expressed for maintaining a requirement that the holder should be in “lawful” possession of a negotiable transport document. Again, it is unclear whether this suggestion received sufficient support in the Working Group.

(iii) if a negotiable electronic record is used, is pursuant to article ~~6-2-4~~ able to demonstrate that it has [access to] [control of] such record.

~~(g)1-18~~ “Right of control”<sup>12</sup> has the meaning given in article ~~49-11-1~~.

~~(h)1-7~~ “Controlling party”<sup>13</sup> means the person that pursuant to article ~~50-11-2~~ is entitled to exercise the right of control.

~~(i)1-2~~ “Consignee”<sup>14</sup> means a person entitled to take delivery of the goods under a contract of carriage or a transport document or electronic record.

~~(j)1-11~~ “Goods” means the wares, merchandise, and articles of every kind [whatsoever that a carrier or a performing party [received for carriage] undertakes to carry under a contract of carriage]<sup>15</sup> and includes the packing and any equipment and container not supplied by or on behalf of ~~a~~ the carrier or a performing party.

~~(k)1-20~~ “Transport document”<sup>16</sup> means a document issued pursuant to a contract of carriage by ~~a~~ the carrier or a performing party that

<sup>12</sup> It was noted in paragraph 105 of A/CN.9/510 that this was more a cross-reference than a definition, and it was proposed that it could therefore be deleted. However, it was agreed by the Working Group to retain the definition for further consideration at a later stage. See also *infra* note 13.

The Working Group may wish to consider whether the first sentence of the chapeau in paragraph 11.1 (now article 53) should be moved to paragraph 1.18 (now paragraph (g)) as the definition of “right of control”. Should the Working Group decide to do so, paragraph (g) could read: “‘Right of control’ means (i) the right to give instructions to the carrier under the contract of carriage and (ii) the right to agree with the carrier to a variation of such contract.”

<sup>13</sup> Noting the concerns expressed in paragraph 87 of A/CN.9/510 regarding the use of index referencing in the definition section, the Working Group agreed that the definition should be retained for further discussions.

<sup>14</sup> As noted in paragraph 75 of A/CN.9/510, it was suggested that the definition might be redrafted along the following lines: “‘Consignee’ means a person entitled to take delivery of the goods under a contract of carriage, which may be expressed by way of a transport document or electronic record”, while another suggestion was that a reference to the controlling party might need to be introduced in the definition of “consignee”. As noted in paragraph 76 of A/CN.9/510, the Working Group took note of those questions, concerns and suggestions for continuation of the discussion at a later stage.

<sup>15</sup> In paragraph 90 of A/CN.9/510, a concern was expressed that the reference in the definition of “goods” that a carrier or a performing party “received for carriage” rather than “undertakes to carry” may mean that the definition failed to cover cases where there was a failure by the carrier to receive the goods or load cargo on board a vessel. It was said that the current reference only to receipt of goods was too narrow, and, alternatively, that the definition should be simplified by removing any reference to receipt of the goods. The Working Group decided that the Secretariat should prepare two alternative texts taking account of each of these approaches, however, the Working Group may wish to consider whether the amendment made above could accommodate the concerns of the Working Group, without the need for either of the two alternative texts.

The Working Group may also wish to note that if the phrase “undertakes to carry under a contract of carriage” is adopted, the complete phrase must be limited to “whatsoever that a carrier undertakes to carry under a contract of carriage”, since the performing party does not undertake to carry the goods under the contract of carriage. However, if the phrase “received for carriage” is adopted, then the complete phrase should be “whatsoever that a carrier or a performing party received for carriage”.

<sup>16</sup> In paragraph 86 of A/CN.9/510, it was suggested with respect to the paragraph 1.6 (now paragraph (r)) definition of “contract particulars” (see, *infra*, note 23) that the text should indicate more clearly to what the phrase “relating to the contract of carriage” referred. In this respect, it

~~(i)(a)~~ evidences a the carrier's or a performing party's receipt of goods under a contract of carriage, or

~~(ii)(b)~~ evidences or contains a contract of carriage,

or both.

~~(l)1.14~~ "Negotiable transport document"<sup>17</sup> means a transport document that indicates, by wording such as "to order" or "negotiable" or other appropriate wording recognized as having the same effect by the law governing the document, that the goods have been consigned to the order of the shipper, to the order of the consignee, or to bearer, and is not explicitly stated as being "non-negotiable" or "not negotiable".

~~(m)1.16~~ "Non-negotiable transport document"<sup>18</sup> means a transport document that does not qualify as a negotiable transport document.

~~(n)1.8~~ "Electronic communication"<sup>19</sup> means communication by electronic, optical, or digital images or by similar means with the result that the information communicated is accessible so as to be usable for subsequent reference. Communication includes generation, storing, sending, and receiving.

~~(o)1.9~~ "Electronic record"<sup>20</sup> means information in one or more messages issued by electronic communication pursuant to a contract of carriage by a carrier or a performing party that

~~(i)(a)~~ evidences a the carrier's or a performing party's receipt of goods under a contract of carriage, or

~~(ii)(b)~~ evidences or contains a contract of carriage,

or both.

It includes information attached or otherwise linked to the electronic record contemporaneously with or subsequent to its issue by the carrier or a performing party.

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was suggested that when the Working Group considered draft paragraphs 1.9 and 1.20 (now paragraphs (o) and (k)) it consider whether the requirement that an electronic communication or a transport document evidences a contract of carriage was really necessary. This definition may be based on s. 5(1) of the UK Carriage of Goods by Sea Act, 1992, but there does not seem to be any doubt that the transport document is also usually evidence of the contract of carriage. It would not, therefore, seem advisable to place square brackets around articles 1.20(b) (now paragraph (k)(ii)) or 1.9(b) (now paragraph (o)(ii)).

<sup>17</sup> It was suggested in paragraph 93 of A/CN.9/510 that there be a clearer explanation of the differences between negotiability and non-negotiability, particularly in order to provide for appropriate rules on negotiable electronic records. In response, it was noted that whilst it was important to be precise in this area, particularly because it was a new area and was affected by national law, the Working Group should keep in mind that it could not regulate all consequences.

<sup>18</sup> As noted in paragraph 94 of A/CN.9/510, although a suggestion was made that this definition was not necessary and should be deleted, the Working Group agreed to retain the definition for further consideration.

<sup>19</sup> As noted in paragraph 88 of A/CN.9/510, a number of concerns have been raised with respect to this provision and to the definition of "electronic record". It should be noted that the discussion of the electronic commerce aspects of the draft instrument have been postponed until later in the Working Group's discussions.

<sup>20</sup> See *supra* notes 16 and 19.

~~(p)1.13~~ “Negotiable electronic record”<sup>21</sup> means an electronic record

(i) that indicates, by statements such as “to order”, or “negotiable”, or other appropriate statements recognized as having the same effect by the law governing the record, that the goods have been consigned to the order of the shipper or to the order of the consignee, and is not explicitly stated as being “non-negotiable” or “not negotiable”, and

(ii) is subject to rules of procedure as referred to in article 6 ~~2.4~~, which include adequate provisions relating to the transfer of that record to a further holder and the manner in which the holder of that record is able to demonstrate that it is such holder.

~~(q)1.15~~ “Non-negotiable electronic record”<sup>22</sup> means an electronic record that does not qualify as a negotiable electronic record.

~~(r)1.6~~ “Contract particulars”<sup>23</sup> means any information relating to the contract of carriage or to the goods (including terms, notations, signatures and endorsements) that appears in a transport document or an electronic record.

~~(s)1.4~~ “Container” ~~includes~~ ~~means~~<sup>24</sup> any type of container, transportable tank or flat, swapbody, or any similar unit load used to consolidate goods, [capable of being carried by sea][designed for carriage by sea] and any equipment ancillary to such unit load.<sup>25</sup>

~~(t)1.10~~ “Freight”<sup>26</sup> means the remuneration payable to ~~a~~ the carrier for the carriage of goods under a contract of carriage.

<sup>21</sup> As noted in paragraph 92 of A/CN.9/510, the Working Group accepted the definitions of “negotiable electronic record” and “non-negotiable electronic record” as a sound basis for further discussions.

<sup>22</sup> Correction to original text following paragraph 13 of A/CN.9WG.III/WP/21. Also, see *supra* note 21.

<sup>23</sup> In paragraph 86 of A/CN.9/510, it is noted that the Working Group agreed that the following concerns should be considering in redrafting the definition: that the definition could contain contradictions when read together with paragraph 1.20 (now paragraph (k)), and that the text should indicate more clearly to what the phrase “relating to the contract of carriage” referred (see *supra* note 16). However, the existence of a contradiction between the definition of “contract particulars” in paragraph 1.6 (now paragraph (r)) and “transport document” is in paragraph 1.20 (now paragraph (k)) is unclear. Further, the phrase “relating to the contract of carriage” would seem to be clear.

<sup>24</sup> It is noted in paragraph 82 of A/CN.9/510 that the Secretariat was requested to prepare a revised definition for “container” with possible variants reflecting the views and concerns expressed. The first such concern expressed in paragraph 81 of A/CN.9/510 was that the word “includes” made the definition open-ended, and the second, expressed in paragraph 82 of A/CN.9/510, was that the definition should be limited to containers designed for sea transport. The suggested changes present alternative language and are an attempt to reflect these views.

<sup>25</sup> To avoid the apparent circularity in the words “‘Container’ means any type of container...”, the Working Group may wish to consider the following alternative text: “‘Container’ means any unit load used to consolidate goods that is [capable of being carried by sea][designed for carriage by sea] and any equipment ancillary to such unit load, [such as][including] transportable tank or flat, swapbody, or any similar unit load.”

<sup>26</sup> A concern was expressed in paragraph 89 of A/CN.9/510 that the definition of freight was incomplete in that it failed to state the person who was liable to pay the freight. However, it was agreed that the role of the definition was simply to describe what freight was and that issues relating to the freight could be dealt with elsewhere.



Article 2.3. Scope of application1.3.1Variant A of paragraph 1<sup>27</sup>

Subject to<sup>28</sup> ~~article paragraph 3.3.1, the provisions of this instrument applies to~~ all contracts of carriage in which the place of receipt and the place of delivery are in different States if

(a) the place of receipt ~~for port of loading~~<sup>29</sup> specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the place of delivery ~~for port of discharge~~ specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]

(d) [the contract of carriage is entered into in a Contracting State or the contract particulars state that the transport document or electronic record is issued in a Contracting State, or]<sup>30</sup>

(e) the contract of carriage provides that ~~the provisions of this instrument, or the law of any State giving effect to them, are is~~ to govern the contract.

<sup>27</sup> Variant A of paragraph 1 is based on the original text of the draft instrument.

<sup>28</sup> The Working Group may wish to review all articles and paragraphs in the draft instrument that begin with the phrase, "Subject to article/paragraph ...", or "Notwithstanding article/paragraph ..." and the like, in order to assess whether, in each case, the clause is necessary or whether it may be deleted. In the interests of achieving consistency, it is suggested that this review be completed by examining the instrument as a whole with this sole purpose in mind.

<sup>29</sup> It was noted in paragraph 244 of A/CN.9/526 that the Working Group agreed on a provisional basis that the draft instrument should cover any type of multimodal carriage involving a sea leg, and that no further distinction would be needed, based on the relative importance of the various modes of transport used for the purposes of the carriage. It was also agreed that draft article 3 (now article 2) might need to be redrafted to better reflect that the internationality of the carriage should be assessed on the basis of the contract of carriage. The Secretariat was requested to prepare revised provisions, with possible variants, for continuation of the discussion at a future session. However, in view of the definition of "contract of carriage" in paragraph 1.5 (now article 1(a)), there would seem to be no need to change the text of paragraph 3.1(a) and (b) (now articles 2(1)(a) and (b)) except that the words in brackets could be deleted.

<sup>30</sup> As noted in paragraph 34 of A/CN.9/510, it was widely held in the Working Group that, in modern transport practice, the place of conclusion of the contract was mostly irrelevant to the performance of the contract of carriage and, if electronic commerce was involved, that place might even be difficult or impossible to determine.

Variant B of paragraph 1<sup>31</sup>

Subject to ~~article paragraph 3.3.1, the provisions of~~ this instrument applies to all contracts of carriage of goods by sea<sup>32</sup> in which the place of receipt and the place of delivery are in different States if

(a) the place of receipt [or port of loading] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the place of delivery [or port of discharge] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]

(d) [the contract of carriage is entered into in a Contracting State or the contract particulars state that the transport document or electronic record is issued in a Contracting State, or]<sup>33</sup>

(e) the contract of carriage provides that ~~the provisions of~~ this Instrument, or the law of any State giving effect to them, ~~are~~ is to govern the contract.

1 bis. This instrument also applies to carriage by inland waterway before and after the voyage by sea as well as to carriage by road or by rail from the place of receipt to the port of loading and from the port of discharge to the place of delivery, provided that the goods, during the sea voyage, have been unloaded from the means of transport with which the land segment of the carriage is performed.<sup>34</sup>

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<sup>31</sup> In paragraphs 245 to 249 of A/CN.9/526, the relationship of the draft instrument with other transport conventions and with domestic legislation is discussed. The Working Group instructed the Secretariat in paragraph 250 of A/CN.9/526, inter alia, to prepare language considering as an option the Swedish proposal to clarify paragraph 3.1 (now paragraph 1) of the draft instrument (see A/CN.9/WG.III/WP.26). This variant is reflected in Variant B.

<sup>32</sup> If Variant B is adopted by the Working Group, the use of the phrase “of goods by sea” may require an amendment to the paragraph 1.5 (now article 1(a)) definition of “contract of carriage”.

<sup>33</sup> See *supra* note 30.

<sup>34</sup> The Working Group may wish to consider the relationship of this paragraph 1 bis with article 83.

Variant C of paragraph 1<sup>35</sup>

Subject to ~~article paragraph 3.3.1, the provisions of this instrument applies~~ to all contracts of carriage in which the ~~place of receipt and the place of delivery port of loading and the port of discharge~~ are in different States if

(a) the ~~place of receipt~~ port of loading specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the ~~place of delivery~~ port of discharge specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or]

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]

(d) [the contract of carriage is entered into in a Contracting State or the contract particulars state that the transport document or electronic record is issued in a Contracting State, or]<sup>36</sup>

(e) the contract of carriage provides that ~~the provisions of this instrument, or the law of any State giving effect to them, are is~~ to govern the contract.<sup>37</sup>

~~2.3.2 The provisions of t~~This instrument applies without regard to the nationality of the ship, the carrier, the performing parties, the shipper, the consignee, or any other interested parties.<sup>38</sup>

~~3.3.3.1 The provisions of t~~This instrument does not apply to charter parties, [contracts of affreightment, volume contracts, or similar agreements].

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<sup>35</sup> A suggestion reflected in paragraph 243 of A/CN.9/526 was that the draft instrument should only apply to those carriages where the maritime leg involved cross-border transport. Under that suggestion, it was said to be irrelevant whether the land legs involved in the overall carriage did or did not involve cross-border transport. The Working Group took note of that suggestion and requested the Secretariat to reflect it, as a possible variant, in the revised draft to be prepared for continuation of the discussion at a future session. Variant C is intended to reflect this approach. As noted in paragraph 243 of A/CN.9/526, the prevailing view, however, was that, pursuant to draft article 3 (now article 2), the internationality of the carriage should not be assessed in respect of any of the individual unimodal legs but in respect of the overall carriage, with the place of receipt and the place of delivery being in different States.

<sup>36</sup> See *supra* note 30.

<sup>37</sup> The Working Group may also wish to consider the addition of paragraph 1 bis to Variant C, as follows: "1 bis. If under the contract of carriage, the goods are carried only partly by sea, this instrument applies however only if (a) the place of receipt and the port of loading are in the same State, and (b) the port of discharge and the place of delivery are in the same State." This suggestion may be in conflict with subparagraph 4.2.1 (now article 8). In addition, as indicated in note 35, *supra*, the prevailing view in the Working Group was that the internationality of the carriage should not be assessed in respect of any of the individual unimodal legs but in respect of the overall carriage, with the place of receipt and the place of delivery being in different States.

<sup>38</sup> It has been suggested that in the interests of uniformity and for the avoidance of doubt, it would be desirable to also include a reference to the applicable law (paragraph 37 of A/CN.9/WG.III/WP.21/Add.1).

~~4.3.3.2~~ Notwithstanding ~~the provisions of article paragraph 3~~ ~~3.3.1~~, if a negotiable transport document or a negotiable electronic record is issued pursuant to a charter party, [contract of affreightment, volume contract, or similar agreement], then the provisions of this instrument apply to the contract evidenced by or contained in that document or that electronic record from the time when and to the extent that the document or the electronic record governs the relations between the carrier and a holder other than the charterer.

~~5.3.4~~ If a contract provides for the future carriage of goods in a series of shipments, ~~the provisions of this instrument apply~~ to each shipment to the extent that ~~articles paragraphs 1, 2, 3 and 4 3.1, 3.2, and 3.3~~ so specify.

## CHAPTER 2. ELECTRONIC COMMUNICATION<sup>39</sup>

### Article 3.

~~2.1~~—Anything that is to be in or on a transport document in pursuance of this instrument may be recorded or communicated by using electronic communication instead of by means of the transport document, provided the issuance and subsequent use of an electronic record is with the express or implied consent of the carrier and the shipper.

### Article 4.

~~1.2.2.1~~—If a negotiable transport document has been issued and the carrier and the holder agree to replace that document by a negotiable electronic record,

(a) the holder shall surrender the negotiable transport document, or all of them if more than one has been issued, to the carrier; and

(b) the carrier shall issue to the holder a negotiable electronic record that includes a statement that it is issued in substitution for the negotiable transport document,

whereupon the negotiable transport document ceases to have any effect or validity.

~~2.2.2.2~~ If a negotiable electronic record has been issued and the carrier and the holder agree to replace that electronic record by a negotiable transport document,

(a) the carrier shall issue to the holder, in substitution for that electronic record, a negotiable transport document that includes a statement that it is issued in substitution for the negotiable electronic record; and

(b) upon such substitution, the electronic record ceases to have any effect or validity.

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<sup>39</sup> The discussion of this chapter has been postponed to a future consideration of the draft instrument. This chapter has been kept in its original position. However the Working Group may wish to consider the optimum placement of it within the draft instrument when its provisions are considered. Further changes to this chapter are expected following those discussions.

Article 5.

~~2.3~~—The notices and confirmation referred to in articles ~~20(1), 6.9.1, 20(2), 6.9.2, 20(3), 6.9.3, 34(1)(b) and (c), 8.2.1 (b) and (e), 47, 10.2, 51, 10.4.2,~~ the declaration in article ~~68 14.3~~ and the agreement as to weight in article ~~37(1)(c) 8.3.1 (e)~~ may be made using electronic communication, provided the use of such means is with the express or implied consent of the party by whom it is communicated and of the party to whom it is communicated. Otherwise, it must be made in writing.

Article 6.

~~2.4~~—The use of a negotiable electronic record is subject to rules of procedure agreed between the carrier and the shipper or the holder mentioned in article ~~1(p)~~<sup>40</sup> ~~2.2.1~~. The rules of procedure shall be referred to in the contract particulars and shall include adequate provisions relating to

- (a) the transfer of that record to a further holder,
- (b) the manner in which the holder of that record is able to demonstrate that it is such holder, and
- (c) the way in which confirmation is given that
  - (i) delivery to the consignee has been effected; or
  - (ii) pursuant to articles ~~4(2) 2.2.2~~ or ~~49(a)(ii) 10.3.2(i)(b)~~, the negotiable electronic record has ceased to have any effect or validity.

CHAPTER 3. 4. PERIOD OF RESPONSIBILITYArticle 7.<sup>41</sup>

~~1.4.1.1~~ Subject to ~~the provisions of~~ article ~~9.4.3~~, the responsibility of the carrier for the goods under this instrument covers the period from the time when the carrier or a performing party has received the goods for carriage until the time when the goods are delivered to the consignee.

~~2.4.1.2~~ The time and location of receipt of the goods is the time and location agreed in the contract of carriage or, failing any specific provision relating to the receipt of the goods in such contract, the time and location that is in accordance with the customs, practices, or usages in the trade. In the absence of any such provisions in the contract of carriage or of such customs, practices, or usages, the time and location of receipt of the goods is when and where the carrier or a performing party actually takes custody of the goods.

~~3.4.1.3~~ The time and location of delivery of the goods is the time and location agreed in the contract of carriage, or, failing any specific provision relating to the delivery of the goods in such contract, the time and location that is in accordance with the customs, practices, or usages in the trade. In the absence of any such specific provision in the contract of carriage or of such customs, practices, or

<sup>40</sup> This is a correction to the original version of the draft instrument set out in A/CN.9/WGIII/WP21, which should have made reference to the definition of “negotiable electronic record” in article 1(p).

<sup>41</sup> The Working Group may wish to note paragraph 40 of A/CN.9/510, which sets out the arguments against, and in favour of, the approach taken in article 7.

usages, the time and location of delivery is that of the discharge or unloading of the goods from the final vessel or vehicle in which they are carried under the contract of carriage.

~~4.4.1.4~~ If the carrier is required to hand over the goods at the place of delivery to an authority or other third party to whom, pursuant to law or regulation applicable at the place of delivery, the goods must be handed over and from whom the consignee may collect them, such handing over will be regarded as a delivery of the goods by the carrier to the consignee under ~~article-paragraph 3 4.1.3~~.

[Article 8. 4.2.1 Carriage preceding or subsequent to sea carriage<sup>42</sup>

1. Where a claim or dispute arises out of loss of or damage to goods or delay occurring solely during either of the following periods:

(a) from the time of receipt of the goods by the carrier or a performing party to the time of their loading on to the vessel;

(b) from the time of their discharge from the vessel to the time of their delivery to the consignee;

and, at the time of such loss, damage or delay, there are provisions of an international convention [or national law] that

(i) according to their terms apply to all or any of the carrier's activities under the contract of carriage during that period, [irrespective whether the issuance of any particular document is needed in order to make such international convention applicable], and

(ii) make specific provisions for carrier's liability, limitation of liability, or time for suit, and

(iii) cannot be departed from by private contract either at all or to the detriment of the shipper, such provisions, to the extent that they are mandatory as indicated in (iii) above, prevail over the provisions of this instrument.]

<sup>42</sup> It is noted in paragraph 250 of A/CN.9/526 that the Working Group agreed provisionally to retain the text of subparagraph 4.2.1 (now article 8) as a means of resolving possible conflicts between the draft instrument and other conventions already in force. The Secretariat was instructed to prepare a conflict of convention provision for possible insertion into article 16 (now chapter 18) of the draft instrument, and to prepare language considering as an option the Swedish proposal to clarify paragraph 3.1 (now article 2(1)). The exchange of views regarding the relationship between the draft instrument and national law was inconclusive, and the decision was made to consider this issue further in light of anticipated future proposals. Given the level of support with respect to the issue of national law, however, the Working Group requested the Secretariat to insert a reference to national law in square brackets into the text of subparagraph 4.2.1 (now article 8) for further reflection in the future. Further, both the text of the Swedish proposal with respect to article 3 (now article 2) and a conflict of law provision in article 16 (now chapter 18), have been inserted in the text of the draft instrument in square brackets.

The Working Group may also wish to consider whether this article is appropriately placed within the draft instrument, or whether it should be moved to another chapter, such as, perhaps, chapter 5 on the Liability of the Carrier.

~~[2. The provisions under article 8 subparagraph 4.2.1 shall not affect the application of article 18(2) 6.7.1 bis.]~~<sup>43</sup>

~~[3.4.2.2 Article 8 4.2.1 applies regardless of the national law otherwise applicable to the contract of carriage.]~~

Article 9. 4.3 Mixed contracts of carriage and forwarding<sup>44</sup>

~~1.4.3.1~~ The parties may expressly agree in the contract of carriage that in respect of a specified part or parts of the transport of the goods the carrier, acting as agent, will arrange carriage by another carrier or carriers.

~~2.4.3.2~~ In such event the carrier shall exercise due diligence in selecting the other carrier, conclude a contract with such other carrier on usual and normal terms, and do everything that is reasonably required to enable such other carrier to perform duly under its contract.

CHAPTER 4. 5. OBLIGATIONS OF THE CARRIER

Article 10.

~~5.1—~~The carrier shall, subject to ~~the provisions of~~ this instrument and in accordance with the terms of the contract of carriage, [properly and carefully] carry the goods to the place of destination and deliver them to the consignee.<sup>45</sup>

Article 11.

~~1.5.2.1—~~The carrier shall during the period of its responsibility as defined in article ~~7 4.1~~, and subject to article ~~8 4.2~~, properly and carefully load, handle, stow, carry, keep, care for and discharge the goods.<sup>46</sup>

<sup>43</sup> In the discussion of the treatment of non-localised damages in paragraphs 264 to 266 of A/CN.9/526, it was suggested in paragraph 266 that the draft instrument might need to reflect more clearly the legal regimes governing localized damages under subparagraph 4.2.1 (now article 8) and non-localized damages under subparagraph 6.7.1 (now article 18(1)). The Secretariat was invited to consider the need for improved consistency between those two provisions when preparing a revised draft of the instrument.

The “improved consistency” between subparagraph 4.2.1 and the new provision subparagraph 6.7.1 bis (now article 18(2)) suggested in paragraph 264 for insertion after subparagraph 6.7.1 (now article 18(1)) (reading as follows: “Notwithstanding the provisions of subparagraph 6.7.1 (now article 18(1)), if the carrier cannot establish whether the goods were lost or damaged during the sea carriage or during the carriage preceding or subsequent to the sea carriage, the highest limit of liability in the international and national mandatory provisions that govern the different parts of the transport shall apply.”) could be realized by adding paragraph (2) as indicated.

<sup>44</sup> The Working Group may wish to consider whether article 9 is properly placed within chapter 3 on period of responsibility.

<sup>45</sup> It was noted in paragraph 116 of A/CN.9/510 that the Working Group provisionally agreed to retain the text of paragraph 5.1 (now article 10) as drafted. It was widely thought that the concerns and drafting suggestions mentioned in paragraphs 113 to 116 of A/CN.9/510 should be revisited at a later stage.

<sup>46</sup> As discussed in paragraph 117 and as noted in paragraph 119 of A/CN.9/510 that, notwithstanding that there was some support for omitting paragraph 5.2.1 (now article 11(1)), the Working Group provisionally agreed to retain the draft article given the extensive experience with analogous provisions in existing conventions such as article 3(2) of the Hague Rules. It was also agreed that

~~[2.5.2.2~~ The parties may agree that certain of the functions referred to in ~~article paragraph 1 5.2.1~~ shall be performed by or on behalf of the shipper, the controlling party or the consignee. Such an agreement must be referred to in the contract particulars.]<sup>47</sup>

Article 12.

5.3

Variant A<sup>48</sup>

Notwithstanding ~~the provisions of articles 10 5.1, 11 5.2, and 13(1) 5.4,~~ the carrier may decline to load, or may unload, destroy, or render goods harmless or take such other measures as are reasonable if goods are, or reasonably appear likely during its period of responsibility to become, a danger to persons or property or an illegal or unacceptable danger to the environment.<sup>49</sup>

Variant B

Notwithstanding articles 10 5.1, 11 5.2, and 13(1) 5.4, the carrier may unload, destroy or render dangerous goods harmless if they become an actual danger to life or property.

Article 13. Additional obligations applicable to the voyage by sea<sup>50</sup>

~~1.5.4~~ The carrier ~~is~~ shall be<sup>51</sup> bound, before, at the beginning of, [and during]<sup>52</sup> the voyage by sea, to exercise due diligence to:

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further study of the draft article should be undertaken to assess the interplay and the consistency between paragraph 5.2.1 (now article 11(1)) and draft article 6 (now chapter 5), as well as the effect of the various possible definitions of the period during which the obligation in paragraph 5.2.1 (now article 11(1)) would apply. The Working Group may wish to note that there does not appear to be a particular maritime orientation to the use of the terms in sub paragraph 5.2.1 (now article 11(1)), and that deletion of the terms could result in a provision setting out only a general standard of care.

<sup>47</sup> It was noted in paragraph 127 of A/CN.9/510 that it was decided that the provision should be placed between square brackets as an indication that the concept of FIO (free in and out) and FIOS (free in and out, stowed) clauses had to be reconsidered by the Working Group including their relationship to the provisions on the liability of the carrier. The Working Group may wish to review this provision based on any changes that are made to articles 10 and 11(1).

It was suggested that written information about the practice of FIO(S) clauses should be prepared for a future session of the Working Group to assist it in its considerations.

<sup>48</sup> Variant A of article 12 is based on the original text of the draft instrument.

<sup>49</sup> It was noted in paragraph 130 of A/CN.9/510 that the Working Group generally agreed that the text of paragraph 5.3 (now article 12) required further improvement. As an alternative to the current text of the provision as represented by Variant A, the Secretariat was requested to prepare a variant, reflected in Variant B, based on the principles expressed in article 13 of the Hamburg Rules regarding the powers of the carrier in case of emergency arising in the transport of dangerous goods. It was also agreed that the issue of compensation that might be owed to the carrier or the shipper in such circumstances might need to be further discussed in the context of paragraph 7.5 (now article 29).

<sup>50</sup> In light of the wide support expressed in the Working Group that the scope of application of the draft instrument should be door-to-door rather than port-to-port (see paragraph 239 of A/CN.9/526), it was thought that separating out provisions of the draft instrument that should apply only to carriage by sea might assist the restructuring of the draft instrument. As a consequence, articles 5 and 6 (now chapters 4 and 5, and a new chapter 6, entitled "Additional provisions relating to carriage by sea [or by other navigable waters]") of the draft instrument have been reorganized in this fashion.

<sup>51</sup> This is the first of several instances where mandatory language has been inserted into the draft instrument in order to use a consistent approach throughout.



- (a) make [and keep] the ship seaworthy;
- (b) properly man, equip and supply the ship;
- (c) make [and keep] the holds and all other parts of the ship in which the goods are carried, including containers where<sup>53</sup> supplied by the carrier, in or upon which the goods are carried fit and safe for their reception, carriage and preservation.<sup>54</sup>

~~[2.5.5 Notwithstanding the provisions of articles 10 5.1, 11 5.2, and 13(1) 5.4, the carrier in the case of carriage by sea [or by inland waterway]<sup>55</sup> may sacrifice goods when the sacrifice is reasonably made for the common safety or for the purpose of preserving other property involved in the common adventure.]<sup>56</sup>~~

## CHAPTER 5. 6. LIABILITY OF THE CARRIER

### Article 14. 6.1 Basis of liability<sup>57</sup>

#### Variant A of paragraphs 1 and 2<sup>58</sup>

~~1.6.1.1~~—The carrier ~~is~~ shall be liable for loss resulting from loss of or damage to the goods, as well as from delay in delivery, if the occurrence that caused the loss, damage or delay took place during the period of the carrier's responsibility as defined in ~~chapter 3 article 4~~, unless the carrier proves that neither its fault nor that of any person referred to in article ~~15(3) 6.3.2(a)~~ caused or contributed to the loss, damage or delay.<sup>59</sup>

<sup>52</sup> As noted in paragraph 131 of A/CN.9/510, the Working Group confirmed its broad support for imposing upon the carrier an obligation of due diligence that was continuous throughout the voyage by retaining the words that were currently between square brackets “and during” and “and keep”. However, a concern was reiterated that the extension of the carrier’s obligation to exercise due diligence in respect of the whole voyage put a greater burden on carriers and could lead to the associated costs being passed on in the form of higher freights.

<sup>53</sup> The Working Group may wish to consider whether “where” should be changed to “when”, since the place in which the containers are supplied is not relevant.

<sup>54</sup> It was noted in paragraph 136 of A/CN.9/510 that the Working Group agreed that the current text of paragraph 5.4 (now paragraph (1)) constituted a workable basis for continuation of its deliberations. The Working Group took note of the various suggestions that had been expressed in respect of the draft provision. It was generally agreed that the draft provision would need to be further considered in light of similar or comparable provisions in other unimodal transport conventions.

<sup>55</sup> This phrase would become redundant if this paragraph were placed under the heading “Additional obligations applicable to the voyage by sea” as suggested in the text.

<sup>56</sup> It was noted in paragraph 143 of A/CN.9/510 that the Working Group was divided between those who favoured the elimination of the subparagraph, and those who preferred to retain it but to further consider its substance. The Working Group decided to place the draft article between square brackets.

<sup>57</sup> Once the Working Group decides upon the preferred variant for paragraphs 1 and 2, it may be advisable to split paragraphs 1, 2 and 3 into separate articles.

<sup>58</sup> Variant A of paragraphs 1 and 2 are based on the original text of the draft instrument.

<sup>59</sup> (a) It was noted in paragraph 34 of A/CN.9/525 that strong support was expressed for the substance of paragraph 6.1 (now article 14). It was also noted in paragraph 34 of A/CN.9/525 that the Working Group requested the Secretariat to prepare a revised draft with due consideration being given to the views expressed and the suggestions made. Variants B and C to subparagraphs 6.1.1 and 6.1.3 (now paragraphs 1 and 2) are presented as possible solutions to the views and suggestions expressed, as noted in the remainder of this note, as well as in notes 61 to 66, *infra*.

[6.1.2<sup>60</sup>]

2. 6.1.3<sup>61</sup>. Notwithstanding the provisions of article paragraph 16.1.1, if the carrier proves that it has complied with its obligations under chapter 4 article 5<sup>62</sup> and that

(b) The suggestion was noted in paragraph 31 of A/CN.9/525 that subparagraph 6.1.1 (now article 14(1)) was closer in substance to the approach taken in article 4.2(q) of the Hague-Visby Rules than the approach taken in article 5.1 of the Hamburg Rules, which required that the carrier prove that it, its servants or agents, took all measures that could reasonably be required to avoid the occurrence and its consequences. However, there was some criticism that the reference to the “period of the carrier’s responsibility as defined in article 4 (now chapter 3)” would allow the carrier to restrict its liability to a considerable extent, since, as noted in paragraph 40 of A/CN.9/510, some reservations were expressed with the approach taken in article 7, according to which the precise moment of the receipt and delivery of goods was a matter of contractual arrangements between the parties of a matter to be decided upon by reference to customs or usages.

(c) As further noted in paragraph 31 of A/CN.9/525, some concern was expressed as to why it had been considered necessary to deviate from the language used in the Hamburg Rules. It was suggested that the reason for the difference in wording from both the Hague Rules and the Hamburg Rules was to improve and provide greater certainty (e.g. as to the fact that the liability of the carrier was based on presumed fault, a matter that had required clarification by way of the common understanding adopted by the drafters of the Hamburg Rules). A contrary view was that combining different languages from both the Hague and Hamburg Rules might increase uncertainty as it was not clear how the provision would be interpreted. Since the views differed, and there is no evidence that one of them prevailed over the other, it does not seem possible to reflect them in the text.

(d) A suggestion was made in paragraph 31 of A/CN.9/525 that the basis of liability should be simplified by abolishing the standard of due diligence and replacing it with liability stemming from use of the vessel as such. This suggestion would entail a very strict, if not objective, standard of liability. Since support was expressed in paragraph 31 of A/CN.9/525 for the requirement of fault-based liability on the carrier, the change that has been suggested would seem to clash with the majority view.

(e) Paragraph 32 of A/CN.9/525 suggested that, whilst a higher standard of liability had been adopted in instruments dealing with other modes of transport (such as COTIF), a higher standard would not be acceptable in the maritime context. In this regard, support was expressed for features in addition to paragraph 6.1 (now article 14), such as draft article 5 (now chapter 4), which set out the positive obligations of the carrier. This suggestion appeared to have the support of the Working Group, and should be taken into consideration.

(f) The original text as presented in Variant A has no clear linkage between article 5 (now chapter 4) and article 6 (now chapter 5) of the draft instrument, i.e. between the breach of the obligations set out in article 5 (now chapter 4) (as well as the allocation of the burden of proof) and the liability of the carrier in accordance with article 6 (now chapter 5). The suggestion that was made is to create such a linkage.

(g) It was noted in paragraph 31 of A/CN.9/525 that if the draft instrument were to apply on a door-to-door basis, conflict with unimodal land transport conventions (such as COTIF and CMR) would be inevitable given that both imposed a higher standard of liability on the carrier. However it was suggested that these conflicts could be reduced by adopting suitable wording in paragraph 6.4 (now article 16) as well as the language used in respect of the performing carrier. More generally, doubts were expressed as to whether default liability rules applicable in the context of door-to-door transport should be based on the lower maritime standard instead of relying on the stricter standard governing land transport.

<sup>60</sup> Moved to new chapter 6 (now chapter 5) under the heading “Additional provisions relating to carriage by sea [or by other navigable waters]”. See *supra* note 50.

<sup>61</sup> Paragraph 45 of A/CN.9/525 notes that the Secretariat was requested to take the suggestions, views and concerns in paragraphs 38 to 44 of A/CN.9/525 into consideration when preparing a future draft of the provision. The prevailing view noted in paragraph 39 was that this provision should be maintained. An attempt has been made in this text to take into account the comments and suggestions made by the Working Group, as noted in paragraphs 40 to 43 of A/CN.9/525.

<sup>62</sup> Paragraph 42 of A/CN.9/525 made reference to concerns that the chapeau of subparagraph 6.1.3 (now paragraph (2)) insufficiently addressed cases where the carrier proved an event in the list

loss of or damage to the goods or delay in delivery has been caused [solely]<sup>63</sup> by one of the following events [it ~~is~~ shall be presumed, in the absence of proof to the contrary, that neither its fault nor that of a performing party has caused [or contributed to cause]<sup>64</sup> that loss, damage or delay]<sup>65</sup> [the carrier shall not be liable, except where proof is given of its fault or of the fault of a performing party, for such loss, damage or delay].<sup>66</sup>

(a)(i) [Act of God], war, hostilities, armed conflict, piracy, terrorism, riots and civil commotions;

(b)(ii) quarantine restrictions; interference by or impediments created by governments, public authorities, rulers or people [including interference by or pursuant to legal process];

(c)(iii) act or omission of the shipper, the controlling party or the consignee;

(d)(iv) — strikes, lock-outs, stoppages or restraints of labour;

[(v) ... <sup>67</sup>;]

(e)(vi) wastage in bulk or weight or any other loss or damage arising from inherent quality, defect, or vice of the goods;

(f)(vii) insufficiency or defective condition of packing or marking;

(g)(viii) latent defects not discoverable by due diligence.

(h)(ix) handling, loading, stowage or unloading of the goods by or on behalf of the shipper, the controlling party or the consignee;

(i)(x) acts of the carrier or a performing party in pursuance of the powers conferred by article ~~12 5.3~~ and ~~13(2) 5.5~~ when the goods have been become a danger to persons, property or the environment or have been sacrificed;

[(xi) ... <sup>68</sup>;]

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under subparagraph 6.1.3 (now paragraph (2)), but there was an indication that the vessel might not have been seaworthy. See also the comments under paragraph 6.1 (now article 14), as noted in note 59, *supra*.

<sup>63</sup> It was suggested in paragraph 42 of A/CN.9/525 that the word “solely” be added to the subparagraph, particularly if the events listed were to be treated as exonerations.

<sup>64</sup> It was suggested in paragraph 42 of A/CN.9/525 Report that the words “or contributed to cause” be deleted, again, particularly if the events listed were to be treated as exonerations.

<sup>65</sup> This is the first alternative based on the “presumption regime” suggested in paragraphs 41 and 42 of A/CN.9/525.

<sup>66</sup> As noted in paragraph 41 of A/CN.9/525, this is the second alternative, based on the traditional exoneration regime, but subject to proof being given of the carrier’s fault.

<sup>67</sup> Moved to new chapter 6 under the heading “Additional provisions relating to carriage by sea [or by other navigable waters]”. See *supra* note 50.

<sup>68</sup> Moved to new chapter 6 under the heading “Additional provisions relating to carriage by sea [or by other navigable waters]”. See *supra* note 50.

Variant B of paragraphs 1 and 2:

1. The carrier is relieved from liability if it proves that:

(i) it has complied with its obligations under article 13.1 [or that its failure to comply has not caused [or contributed to]<sup>69</sup> the loss, damage or delay], and

(ii) neither its fault, nor the fault of its servants or agents has caused [or contributed to]<sup>70</sup> the loss, damage or delay, or

that the loss, damage or delay has been caused by one of the following events:

(a)(i) [Act of God], war, hostilities, armed conflict, piracy, terrorism, riots and civil commotions;

(b)(ii) quarantine restrictions; interference by or impediments created by governments, public authorities rulers or people [including interference by or pursuant to legal process];

(c)(iii)—act or omission of the shipper, the controlling party or the consignee;

(d)(iv)—strikes, lock-outs, stoppages or restraints of labour;

[(v) ... <sup>71</sup>];

(e)(vi) wastage in bulk or weight or any other loss or damage arising from inherent quality, defect, or vice of the goods;

(f)(vii) insufficiency or defective condition of packing or marking;

(g)(viii) latent defects not discoverable by due diligence.

(h)(ix) handling, loading, stowage or unloading of the goods by or on behalf of the shipper, the controlling party or the consignee;

(i)(x) acts of the carrier or a performing party in pursuance of the powers conferred by article 12.5.3 and 13(2).5.5 when the goods have been become a danger to persons, property or the environment or have been sacrificed;

[(xi) ... <sup>72</sup>];

<sup>69</sup> See note 64, *supra*.

<sup>70</sup> *Ibid*.

<sup>71</sup> Moved to new chapter 6 under the heading “Additional provisions relating to carriage by sea [or by other navigable waters]”. See *supra* note 50.

<sup>72</sup> Moved to new chapter 6 under the heading “Additional provisions relating to carriage by sea [or by other navigable waters]”. See *supra* note 50.

The carrier shall, however, be liable for the loss, damage or delay if the shipper proves that the fault of the carrier or the fault of its servants or agents has caused [or contributed to]<sup>73</sup> the loss, damage or delay.

Variant C of paragraphs 1 and 2

1. The carrier ~~is~~ shall be liable for loss resulting from loss of or damage to the goods, as well as from delay in delivery, if the occurrence that caused the loss, damage or delay took place during the period of the carrier's responsibility as defined in chapter 3 article 4.

2. The carrier is relieved of its liability under paragraph 1 if it proves that neither its fault nor that of any person referred to in article 15(3) 6.3.2(a) caused [or contributed to]<sup>74</sup> the loss, damage or delay.

2.bis It shall be presumed that neither its fault nor that of any person referred to in article 15(3) caused the loss, damage or delay if the carrier proves that loss of or damage to the goods or delay in delivery has been caused [solely]<sup>75</sup> by one of the following events:

(a)(i) [Act of God], war, hostilities, armed conflict, piracy, terrorism, riots and civil commotions;

(b)(ii) quarantine restrictions; interference by or impediments created by governments, public authorities rulers or people [including interference by or pursuant to legal process];

(c)(iii) —act or omission of the shipper, the controlling party or the consignee;

(d)(iv) —strikes, lock-outs, stoppages or restraints of labour;

[(v) ... <sup>76</sup>;]

(e)(vi) wastage in bulk or weight or any other loss or damage arising from inherent quality, defect, or vice of the goods;

(f)(vii) insufficiency or defective condition of packing or marking;

(g)(viii) latent defects not discoverable by due diligence.

(h)(ix) handling, loading, stowage or unloading of the goods by or on behalf of the shipper, the controlling party or the consignee;

(i)(x) acts of the carrier or a performing party in pursuance of the powers conferred by article 12 5.3 and 13(2) 5.5 when the goods have been become a danger to persons, property or the environment or have been sacrificed;

[(xi) ... <sup>77</sup>;]

<sup>73</sup> See note 64, *supra*.

<sup>74</sup> See note 64, *supra*.

<sup>75</sup> See note 63, *supra*.

<sup>76</sup> Moved to new chapter 6 under the heading “Additional provisions relating to carriage by sea [or by other navigable waters]”. See *supra* note 50.

<sup>77</sup> Moved to new chapter 6 under the heading “Additional provisions relating to carriage by sea [or by other navigable waters]”. See *supra* note 50.

The presumption is rebutted if the claimant proves that the loss, damage or delay was caused by the fault of the carrier or any person referred to in article 15 (3). Furthermore the presumption is rebutted if the claimant proves that the loss, damage or delay was caused by one of the cases listed in article 13 (1)(a), (b) or (c). However, in such a case, the carrier is relieved of liability if it proves compliance with the duty under article 13.

~~3. 6.1.4 [If loss, damage or delay in delivery is caused in part by an event<sup>78</sup> for which the carrier is not liable and in part by an event for which the carrier is liable, the carrier is liable for all the loss, damage, or delay in delivery except to the extent that it proves that a specified part of the loss was caused by an event for which it is not liable.]~~

~~[If loss, damage, or delay in delivery is caused in part by an event for which the carrier is not liable and in part by an event for which the carrier is liable, then the carrier is~~

~~— (a) liable for the loss, damage, or delay in delivery to the extent that the party seeking to recover for the loss, damage, or delay proves that it was attributable to one or more events for which the carrier is liable; and~~

~~— (b) not liable for the loss, damage, or delay in delivery to the extent the carrier proves that it is attributable to one or more events for which the carrier is not liable.~~

~~If there is no evidence on which the overall apportionment can be established, then the carrier is liable for one half of the loss, damage, or delay in delivery.]<sup>79</sup>~~

[6.2 Calculation of compensation<sup>80</sup>]

<sup>78</sup> As noted in paragraph 55 of A/CN.9/525, one concern raised was the ambiguous nature of the “event”, and whether it was intended to be limited to “cause”, and whether it would be limited to the list of presumptions in subparagraph 6.1.3 (now paragraph 2).

<sup>79</sup> The text that has been deleted was included as a second alternative in the first draft of the draft instrument. As noted in paragraph 56 of A/CN.9/525, the first alternative received the strongest support in the Working Group and the decision was made to maintain only the first alternative in the draft instrument for the continuation of the discussion at a later stage. However, the Working Group decided to preserve the second alternative as a note or in the comments to the draft text, to permit further consideration of that alternative at a later stage:

[If loss, damage, or delay in delivery is caused in part by an event for which the carrier is not liable and in part by an event for which the carrier is liable, then the carrier is

(a) liable for the loss, damage, or delay in delivery to the extent that the party seeking to recover for the loss, damage, or delay proves that it was attributable to one or more events for which the carrier is liable; and

(b) not liable for the loss, damage, or delay in delivery to the extent the carrier proves that it is attributable to one or more events for which the carrier is not liable.

If there is no evidence on which the overall apportionment can be established, then the carrier is liable for one-half of the loss, damage, or delay in delivery.]

<sup>80</sup> As suggested in paragraph 60 of A/CN.9/525, paragraph 6.2 (now article 17) has been moved after article 6.4 (now article 16) in order to ensure its closer connection with paragraph 6.7 (now article 18).

Article 15.6.3 Liability of performing parties<sup>81</sup>1.6.3.1—(a) Variant A of paragraph 1<sup>82</sup>

A performing party is subject to the responsibilities and liabilities imposed on the carrier under this instrument, and entitled to the carrier's rights and immunities provided by this instrument (a) ~~(i)~~ during the period in which it has custody of the goods; and (b) ~~(ii)~~ at any other time to the extent that it is participating in the performance of any of the activities contemplated by the contract of carriage.

<sup>81</sup> (a) As noted in paragraph 64 of A/CN.9/525, it was agreed that paragraph 6.3 (now article 15) should be retained, subject to a revision of the text taking account of the concerns expressed and to considering whether further changes were necessary if the draft instrument ultimately applied on a door-to-door basis.

An analysis of the "concerns" summarized in paragraph 64 follows in order to ascertain which may be taken into account in the preparation of a revised text.

(b) A concern was expressed that the coverage of performing parties was a novel rule which created a direct right of action as against a party with whom the cargo interests did not have a contractual relationship. It was strongly argued that this innovation should be avoided as it had the potential for serious practical problems. Disagreement was expressed with respect to the statement in paragraph 94 of document A/CN.9/WG.III/WP.21 that a performing party was not liable in tort. In this respect, it was argued that liability of the performing party in tort was a matter of national law to which the present instrument did not extend. Since the Working Group decided to retain this provision, the above concerns cannot be considered.

(c) Also it was submitted that it was not clear under which conditions liability could be imposed upon the performing party. It was said that even though it appeared that the loss or damage had to be "localized" with the performing party (i.e. the loss or damage had to have occurred when the goods were in the performing party's custody), it was less than clear how the burden of proof on this point was to be dealt with. It was suggested that one interpretation could require that the performing party prove that the loss or damage occurred at a time when the goods were not in that party's custody. The burden of proof should be on the claimant and this should be stated. An effort to remedy this concern was made in the suggested alternative text for subparagraph 6.3.1(a) (now article 15(1)).

(d) As well it was suggested that, whilst subparagraph 6.3.4 (now article 15(6)) created joint and several liabilities, it did not indicate how the recourse action as between the parties was to be determined. This was particularly ambiguous given that there was not necessarily a contractual relationship between the parties concerned. However, it is thought that it may be preferable to avoid regulating the recourse actions between parties who are jointly and severally liable. This has not been done in the Hague-Visby Rules (article 4 bis) nor in the Hamburg Rules (article 7).

(e) For these reasons, it was suggested in paragraph 64 of A/CN.9/525 that paragraph 6.3 (now article 15) and the definition of "performing party" in draft article 1 should be deleted or, in the alternative, that the definition should be clarified so as to ensure that it was limited to "physically" performing parties. Support was expressed for limiting the scope of paragraph 6.3 (now article 15) to "physically" performing parties. In this respect it was suggested that the words "or undertakes to perform" should be deleted from subparagraph 6.3.2(a)(ii) (now paragraph 3(b)). However, the existing definition of "performing party" in paragraph 1.17 (now paragraph 1(e)) of the draft instrument clearly states that such is a party that physically performs any of the carrier's responsibilities, so no changes to this provision would seem to be necessary.

(f) It should be noted that in paragraphs 251 to 255 of A/CN.9/526, when discussing the scope of application of the instrument, the Working Group also considered the issue of the treatment of performing parties. As noted in paragraph 256 of A/CN.9/526, it was agreed that the treatment of performing parties under the draft instrument was an important matter that would shape the entire instrument, and could help in the solution of other problems, such as the inclusion of mandatory national law in subparagraph 4.2.1 (now article 8). The anticipation of a more refined written proposal on this issue prevented a clear final or interim decision from being made at that stage. That proposal is now contained in A/CN.9/WG.III/WP.34. In light of this proposal, the Working Group may wish to consider the treatment of performing parties, as well as the other issues discussed therein.

<sup>82</sup> Variant A of paragraph 1 is based on the original text of the draft instrument.

Variant B of paragraph 1

A performing party is liable for loss resulting from loss of or damage to the goods as well as from delay in delivery, if the occurrence that caused the loss, damage or delay took place:

(a) ~~(i)~~ during the period in which it has custody of the goods; or

(b) ~~(ii)~~ at any other time to the extent that it is participating in the performance of any of the activities contemplated by the contract of carriage provided the loss, damage or delay occurred during the performance of such activities.

The responsibilities and liabilities imposed on the carrier under this instrument and the carrier's rights and immunities provided by this instrument shall apply in respect of performing parties.

~~2.~~—(b) If the carrier agrees to assume responsibilities other than those imposed on the carrier under this instrument, or agrees that its liability for the delay in delivery of, loss of, or damage to or in connection with the goods ~~is shall be~~ higher than the limits imposed under articles ~~16(2) 6.4.2, 24(4) 6.6.4, and 18 6.7,~~ a performing party ~~is shall~~ not ~~be~~ bound by this agreement unless the performing party expressly agrees to accept such responsibilities or such limits.

~~3. 6.3.2~~—(a) Subject to ~~article paragraph 5 6.3.3,~~ the carrier ~~is shall be~~ responsible for the acts and omissions of

(a) ~~(i)~~ any performing party, and

(b) ~~(ii)~~ any other person, including a performing party's sub-contractors and agents, who performs or undertakes to perform any of the carrier's responsibilities under the contract of carriage, to the extent that the person acts, either directly or indirectly, at the carrier's request or under the carrier's supervision or control, as if such acts or omissions were its own. ~~A~~ The carrier is responsible under this provision only when the performing party's or other person's act or omission is within the scope of its contract, employment, or agency.

~~4.~~—(b) Subject to ~~article paragraph 5 6.3.3,~~ a performing party ~~is shall be~~ responsible for the acts and omissions of any person to whom it has delegated the performance of any of the carrier's responsibilities under the contract of carriage, including its sub-contractors, employees, and agents, as if such acts or omissions were its own. A performing party is responsible under this provision only when the act or omission of the person concerned is within the scope of its contract, employment, or agency.<sup>83</sup>

~~5. 6.3.3~~ If an action is brought against any person, other than the carrier, mentioned in ~~article paragraphs 3 and 4 6.3.2,~~ that person is entitled to the benefit of the defences and limitations of liability available to the carrier under this instrument if it proves that it acted within the scope of its contract, employment, or agency.

~~6. 6.3.4~~ If more than one person is liable for the loss of, damage to, or delay in delivery of the goods, their liability is joint and several but only up to the limits provided for in articles ~~16 6.4, 24 6.6 and 18 6.7.~~

<sup>83</sup> Language correction to reflect that used in 6.3.2(a) and 6.3.3 (now paragraphs 3, 4 and 5).



~~7.6.3.5~~ Without prejudice to ~~the provisions of article 19 6.8~~, the aggregate liability of all such persons shall not exceed the overall limits of liability under this instrument

Article 16. 6.4 Delay<sup>84</sup>

~~1. 6.4.1~~ Delay in delivery occurs when the goods are not delivered at the place of destination provided for in the contract of carriage within any time expressly agreed upon [or, in the absence of such agreement, within the time it would be reasonable to expect of a diligent carrier, having regard to the terms of the contract, the characteristics of the transport, and the circumstances of the voyage].

~~2. 6.4.2~~ If delay in delivery causes loss not resulting from loss of or damage to the goods carried and hence not covered by article ~~17 6.2~~, the amount payable as compensation for such loss ~~is~~ shall be limited to an amount equivalent to [. . . times the freight payable on the goods delayed]. The total amount payable under this provision and article ~~18(1) 6.7.1~~ shall not exceed the limit that would be established under article ~~18(1) 6.7.1~~ in respect of the total loss of the goods concerned.

[6.5 Deviation<sup>85</sup>]

[6.6 Deck cargo<sup>86</sup>]

Article 17. 6.2 Calculation of compensation<sup>87</sup>

~~1. 6.2.1~~ ~~If the carrier is liable for loss of or damage to the goods~~ Subject to article 18 6.7<sup>88</sup>, the compensation payable by the carrier for loss of or damage to the goods shall be calculated by reference to the value of such goods at the place and time of delivery according to the contract of carriage.

~~2. 6.2.2~~ The value of the goods shall be fixed according to the commodity exchange price or, if there is no such price, according to their market price or, if there is no commodity exchange price or market price, by reference to the normal value of the goods of the same kind and quality at the place of delivery.

~~3. 6.2.3~~ In case of loss of or damage to the goods ~~and save as provided for in article 16 6.4~~<sup>89</sup>, the carrier shall not be liable for payment of any compensation beyond what is provided for in articles paragraphs 1 and 2 6.2.1 and 6.2.2 except where the carrier and the shipper have agreed to calculate compensation in a different manner within the limits of article 88<sup>90</sup>.

<sup>84</sup> As noted in paragraph 70 of A/CN.9/525, the Working Group agreed that the text of paragraph 6.4 (now article 16) would remain as currently drafted for continuation of the discussion at a later stage.

<sup>85</sup> Moved to new chapter 6 under the heading "Additional provisions relating to carriage by sea [or by other navigable waters]". See *supra* note 50.

<sup>86</sup> Moved to new chapter 6 under the heading "Additional provisions relating to carriage by sea [or by other navigable waters]". See *supra* note 50.

<sup>87</sup> See *supra* note 80.

<sup>88</sup> A linkage between the provisions relating to the calculation of compensation and the limits of liability was suggested in paragraph 60 of A/CN.9/525.

<sup>89</sup> The words that have been stricken out do not seem necessary, since paragraph 6.4 (now article 16) deals only with financial loss.

<sup>90</sup> Further to paragraphs 57 to 59 of A/CN.9/525, this phrase was intended to include a provision standardizing the calculation of the compensation, and that this calculation should take account

Article 18. 6.7 Limits of liability<sup>91</sup>

~~1 6.7.1~~ Subject to article ~~16(2) 6.4.2~~ the carrier's liability for loss of or damage to or in connection with the goods is limited to [...] units of account per package or other shipping unit, or [...] units of account per kilogram of the gross weight of the goods lost or damaged, whichever is the higher, except where the nature and value of the goods has been declared by the shipper before shipment and included in the contract particulars, ~~for~~ where a higher amount than the amount of limitation of liability set out in this article has been agreed upon between the carrier and the shipper.<sup>92</sup>

2. 6.7.1bis Notwithstanding paragraph 1 6.7.1, if the carrier cannot establish whether the goods were lost or damaged during the sea carriage or during the carriage preceding or subsequent to the sea carriage, the highest limit of liability in the international and national mandatory provisions that govern the different parts of the transport shall apply.<sup>93</sup>

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of the intention of the parties as expressed in the contract of carriage. As noted in paragraph 58 of A/CN.9/525, it was suggested that whether or not consequential damages should be included in the compensation payable should depend on what was the intention of the parties.

<sup>91</sup> It was noted in paragraph 85 of A/CN.9/525 that the Working Group decided to retain the entire text of paragraph 6.7 (now article 18) in the draft instrument for continuation of the discussion at a later stage.

During the 11th session of the Working Group, the scope of application of the instrument was discussed, and in conjunction with that discussion, the subject of limits of liability was also discussed. As noted in paragraphs 257 to 263 of A/CN.9/526, several suggestions were made with respect to limits of liability, but at this stage no instructions were given to the Secretariat. As noted in paragraph 257 of A/CN.9/526, there was, however, wide support for the suggestions that no attempt should be made to reach an agreement on any specific amount for the limits of liability under this provision at the current stage of the discussion, and that a rapid amendment procedure for the limit on liability should be established by the draft instrument.

<sup>92</sup> As noted in paragraph 259 of A/CN.9/526, the Working Group recalled that the final phrase in subparagraph 6.7.1 (now paragraph 1) was bracketed pending a decision as to whether any mandatory provision should be one-sided or two-sided mandatory, and that the Working Group agreed provisionally that the square brackets should be removed.

The Working Group may also wish to consider the following alternative language for paragraph 1: "Subject to article ~~16(2) 6.4.2~~ the carrier's liability for loss of or damage to or in connection with the goods is limited to [...] units of account per package or other shipping unit, or [...] units of account per kilogram of the gross weight of the goods lost or damaged, whichever is the higher, ~~except~~ However, where the nature and value of the goods has been declared by the shipper before shipment and included in the contract particulars, ~~for~~ where a higher amount than the amount of limitation of liability set out in this article has been agreed upon between the carrier and the shipper, the compensation payable is limited to such amount." The Working Group may wish to note that the final additional phrase of this alternative text should be reassessed in light of article 88, as it may be unnecessary if article 88 is adopted. The Working Group may wish to consider the method that should be used for determining an amount, possibly through the use of statistical data.

<sup>93</sup> Further, when discussing the issue relating to the treatment of non-localised damages, the proposal was made in paragraph 264 of A/CN.9/526, and adopted by the Working Group in paragraph 267, to insert this paragraph after subparagraph 6.7.1 (now paragraph 1) in square brackets. It now appears as paragraph 2.

The following presents several different alternatives for paragraph 2: "Notwithstanding paragraph 1, if the carrier cannot establish whether the goods were lost or damaged during the sea carriage or during [the carriage preceding or subsequent to the sea carriage][either of the periods referred to in article 8(1)(a) and (b)], the highest limit of liability [in the international

~~3.6.7.2~~ When goods are carried in or on a container, the packages or shipping units enumerated in the contract particulars as packed in or on such container are deemed packages or shipping units. If not so enumerated, the goods in or on such container are deemed one shipping unit.

~~4.6.7.3~~ The unit of account referred to in this article is the Special Drawing Right as defined by the International Monetary Fund. The amounts mentioned in this article are to be converted into the national currency of a State according to the value of such currency at the date of judgement or the date agreed upon by the parties. The value of a national currency, in terms of the Special Drawing Rights, of a Contracting State that is a member of the International Monetary Fund is to be calculated in accordance with the method of valuation applied by the International Monetary Fund in effect at the date in question for its operations and transactions. The value of a national currency, in terms of the Special Drawing Right, of a Contracting State that is not a member of the International Monetary Fund is to be calculated in a manner to be determined by that State.

Article 19 ~~6.8~~ Loss of the right to limit liability

Neither the carrier nor any of the persons mentioned in article 15(3) and (4) ~~6.3.2~~ is shall be entitled to limit their liability as provided in articles [~~16(2) ~~6.4.2,~~~~] 24(4) ~~6.6.4,~~ and 18 ~~6.7~~ of this instrument, [or as provided in the contract of carriage,] if the claimant proves that [the delay in delivery of,] the loss of, or the damage to or in connection with the goods resulted from a [personal]<sup>94</sup> act or omission of the person claiming a right to limit done with the intent to cause such loss or damage, or recklessly and with knowledge that such loss or damage would probably result.

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[and national] mandatory provisions that govern the different parts of the transport][provided for in any international convention [or national law] that may apply in accordance with article 8][that would have governed any contract which would have been concluded between the parties for each part of the carriage which involved one mode of transport][that would have been applicable had a specific contract been made for that mode of transport] shall apply.”

<sup>94</sup> During the initial discussion of this provision, as noted in paragraph 92 of A/CN.9/525, the Working Group took note of the comments and suggestions made and decided to maintain the text of paragraph 6.8 (now article 19) in the draft instrument for continuation of the discussion at a later stage. As noted in paragraphs 260 and 261 of A/CN.9/526, however, after a discussion concerning the reference to the “personal act or omission” of the person claiming the right to the liability limit, the Working Group agreed to place the word “personal” between square brackets for continuation of the discussion at a later stage.

Article 206-9 Notice of loss, damage, or delay

1. 6.9.1 The carrier ~~is shall be~~ presumed, in absence of proof to the contrary, to have delivered the goods according to their description in the contract particulars unless notice<sup>95</sup> of loss of or damage to [or in connection with]<sup>96</sup> the goods, indicating the general nature of such loss or damage, ~~was shall have been~~ given [by or on behalf of the consignee]<sup>97</sup> to the carrier or the performing party who delivered the goods before or at the time of the delivery, or, if the loss or damage is not apparent, within [three working days][a reasonable time][ working days at the place of delivery][ consecutive days]<sup>98</sup> after the delivery of the goods. Such a notice is not required in respect of loss or damage that is ascertained in a joint inspection<sup>99</sup> of the goods by the consignee and the carrier or the performing party against whom liability is being asserted.

2. 6.9.2 No compensation ~~is shall be~~ payable under article ~~16 6.4~~ unless notice of such loss<sup>100</sup> was given to the person against whom liability is being asserted within 21 consecutive days following delivery of the goods.

3. 6.9.3 When the notice referred to in this chapter is given to the performing party that delivered the goods, it ~~has shall have~~ the same effect as if that notice was given to the carrier, and notice given to the carrier ~~has shall have~~ the same effect as a notice given to the performing party that delivered the goods.

4. 6.9.4 In the case of any actual or apprehended loss or damage, the parties to the claim or dispute must give all reasonable facilities to each other for inspecting and tallying the goods and [for][must provide] access to records and documents relevant to the carriage of the goods<sup>101</sup>.

Article 216-10 Non-contractual claims

The defences and limits of liability provided for in this instrument and the responsibilities imposed by this instrument apply in any action against the carrier or a performing party for loss of, for damage to, or in connection with the goods

<sup>95</sup> Paragraph 94 of A/CN.9/525 instructs the Secretariat to take account both the broad support for written notice and for the accommodation of electronic communications when preparing the revised draft of the text. Paragraph 2.3 (now article 5) of the draft instrument states that the notice in, *inter alia*, subparagraph 6.9.1 (now paragraph 1) may be made using electronic communication; otherwise, it must be made in writing.

<sup>96</sup> In accordance with the comments in paragraph 97 of A/CN.9/525, the words “or in connection with” have been placed in square brackets and the words “by or on behalf of the consignee” have been added. It is possible that such comments have not met with sufficient support.

<sup>97</sup> *Ibid.*

<sup>98</sup> Paragraph 95 of A/CN.9/525 instructed the Secretariat to place “three working” in square brackets, together with other possible alternatives.

<sup>99</sup> It was suggested in paragraph 95 of A/CN.9/525 that “concurrent inspection” or “*inspection contradictoire*” might be more appropriated phrases in a civil law context.

<sup>100</sup> The Working Group may wish to consider whether language should be added to indicate that this loss should be limited to the loss for delay.

<sup>101</sup> Paragraph 100 of A/CN.9/525 noted that the provision should also include reference to providing access to records and documents relevant to the carriage of goods. The words in square brackets indicate two alternatives: the first link the access to the obligation to give “reasonable facilities”, the second is independent and the notion of reasonability is not applied to it.

covered by a contract of carriage and delay in delivery of such goods<sup>102</sup>, whether the action is founded in contract, in tort, or otherwise.

CHAPTER 6. ADDITIONAL PROVISIONS RELATING TO CARRIAGE BY SEA  
[OR BY OTHER NAVIGABLE WATERS]<sup>103</sup>

Article 22. Liability of the carrier<sup>104</sup>

Variant A<sup>105</sup>

~~16.1.2~~ [Notwithstanding the provisions of article ~~14(1)~~ ~~6.1.1~~ the carrier ~~is~~ shall not ~~be liable-responsible~~ for loss, damage or delay arising or resulting from

~~(a) act, neglect or default of the master, mariner, pilot or other servants of the carrier in the navigation or in the management of the ship;~~

~~— [(b) fire on the ship, unless caused by the fault or privity of the carrier.]~~<sup>106</sup>

~~26.1.3 bis~~ Article 14 shall also apply in the case of the following events:

~~(a) (v)~~ saving or attempting to save life or property at sea; and

~~[(b) (xi)~~ perils, dangers and accidents of the sea or other navigable waters;]

<sup>102</sup> Paragraph 102 of A/CN.9/525 noted wide support for the inclusion of a reference to delay in delivery.

<sup>103</sup> As noted in note 50, *supra*, in light of the wide support expressed in the Working Group that the scope of application of the draft instrument should be door-to-door rather than port-to-port (see paragraph 239 of A/CN.9/526), it was thought that separating out provisions of the draft instrument that should apply only to the carriage by sea might assist the restructuring of the draft instrument. As a consequence, the following provisions in article 6 (now chapter 5) have been moved from their position in the original draft to be grouped together under this heading: subparagraph 6.1.2 (now article 22) and the relevant portions of subparagraph 6.1.3 (now also in article 22) on the basis of liability, paragraph 6.5 (now article 23) on deviation, and paragraph 6.6 (now article 24) on deck cargo.

<sup>104</sup> If Variant B or C for articles 14(1) and (2) is adopted, the Working Group may wish to re-examine this article with a view to adopting a consistent approach in terms of the shifting presumptions.

<sup>105</sup> Variant A of article 22 is based on the original text of the draft instrument.

<sup>106</sup> Subparagraph 6.1.2(a) has been deleted in view of the statements in paragraphs 36 and 37 of A/CN.9/525 that it was widely felt that the removal of that exception from the international regime governing carriage of goods by sea would constitute an important step towards modernizing and harmonizing international transport law. It was also emphasized that such a step might be essential in the context of establishing international rules for door-to-door transport. A related view was that, although it was probably inevitable to do away with the general exception based on error in navigation, subparagraph (a) should be maintained in square brackets pending a final decision to be made at a later stage on what was referred to as “the liability package” (i.e., the various aspects of the liability regime applicable to the various parties involved). After discussion, however, the Working Group decided that subparagraph (a) should be deleted. Subparagraph 6.1.2(b) (now article 22(1)) was kept in square brackets pursuant to the decision of the Working Group in paragraph 37 of A/CN.9/525.

In paragraph 43 of A/CN.9/525, it is noted that the suggestion was made that if the case of fire on the ship were to be maintained, it should be moved from subparagraph 6.1.2 to subparagraph 6.1.3 (now both contained in article 22). This has not been done in Variant A, but it has been done in Variant B.

Variant B

6.1.2 ~~[Notwithstanding the provisions of article 14(1) 6.1.1 the carrier is shall not be responsible for loss, damage or delay arising or resulting from~~

~~— (a) act, neglect or default of the master, mariner, pilot or other servants of the carrier in the navigation or in the management of the ship;~~

~~— [(b) fire on the ship, unless caused by the fault or privity of the carrier.]<sup>107</sup>~~

6.1.3 *bis* Article 14 shall also apply in the case of the following events:

(a) ~~(v)~~ saving or attempting to save life or property at sea;

~~[(b) (xi) perils, dangers and accidents of the sea or other navigable waters;]~~  
[and]

~~[(c) (ix) fire on the ship, unless caused by fault or privity of the carrier;]<sup>108</sup>~~

Article 23. 6-5 Deviation

1. ~~(a)~~ The carrier is not liable for loss, damage, or delay in delivery caused by a deviation<sup>109</sup> to save or attempt to save life [or property]<sup>110</sup> at sea[, or by any other [reasonable] deviation]<sup>111</sup>.

2. ~~(b)~~ Where under national law a deviation of itself constitutes a breach of the carrier's obligations, such breach only has effect consistently with ~~the provisions of~~ this instrument.<sup>112</sup>

<sup>107</sup> See *supra* note 106.

<sup>108</sup> In paragraph 43 of A/CN.9/525, it is noted that the suggestion was made that if the case of fire on the ship were to be maintained, it should be moved from subparagraph 6.1.2 to subparagraph 6.1.3 (now article 22).

<sup>109</sup> The Working Group may wish to consider whether, as noted in paragraph 73 of A/CN.9/525, the phrase "authorized by the shipper or a deviation" should be inserted after the phrase "... in delivery caused by a deviation" should be added.

<sup>110</sup> Further to paragraph 72 of A/CN.9/525, reference to salvage of property has been placed in square brackets because objections were raised to the inclusion of salvage of property..

<sup>111</sup> The reference to any other reasonable deviation has been placed in square brackets since concerns were raised with respect to its use in paragraph 73 of A/CN.9/525. It was also suggested in paragraph 72 of A/CN.9/525 that the draft article could include language to the effect that, when goods are salvaged as a result of the deviation, compensation received as a result of the salvage could be used as compensation for loss caused by the resulting delay.

<sup>112</sup> Alternative language for this paragraph could read as follows: "Where under national law a deviation of itself constitutes a breach of the carrier's obligations, such breach would not deprive the carrier or a performing party of any defence or limitation of this instrument." If such language is adopted, the Working Group may wish to consider whether paragraph 1 is necessary.

Article 24. 6.6 Deck cargo<sup>113</sup>

1. 6.6.1 Goods may be carried on or above deck only if

(a) ~~(i)~~ such carriage is required by applicable laws or administrative rules or regulations, or

(b) ~~(ii)~~ they are carried in or on containers on decks that are specially fitted to carry such containers, or

(c) ~~(iii)~~ in cases not covered by paragraphs ~~(a) (i)~~ or ~~(b) (ii)~~ of this article, the carriage on deck is in accordance with the contract of carriage, or complies with the customs, usages, and practices of the trade, or follows from other usages or practices in the trade in question.

2. 6.6.2 If the goods have been shipped in accordance with ~~article paragraphs 1(a) and (c) 6.6.1(i) and (iii)~~, the carrier ~~is~~ shall not ~~be~~ liable for loss of or damage to these goods or delay in delivery caused by the special risks involved in their carriage on deck. If the goods are carried on or above deck pursuant to ~~article paragraph 1(b) 6.6.1(ii)~~, the carrier ~~is~~ shall be liable for loss of or damage to such goods, or for delay in delivery, under the terms of this instrument without regard to whether they are carried on or above deck. If the goods are carried on deck in cases other than those permitted under ~~article paragraph 1 6.6.1~~, the carrier ~~is~~ shall be liable, irrespective of ~~the provisions of article 14 6.1~~, for loss of or damage to the goods or delay in delivery that are exclusively the consequence of their carriage on deck.

3. 6.6.3 If the goods have been shipped in accordance with ~~article paragraph 1(c) 6.6.1(iii)~~, the fact that particular goods are carried on deck must be included in the contract particulars. Failing this, the carrier ~~has~~ shall have the burden of proving that carriage on deck complies with ~~article paragraph 1(c) 6.6.1(iii)~~ and, if a negotiable transport document or a negotiable electronic record is issued, is not entitled to invoke that provision against a third party that has acquired such negotiable transport document or electronic record in good faith.

4. 6.6.4 If the carrier under this article ~~24 6.6~~ is liable for loss or damage to goods carried on deck or for delay in their delivery, its liability is limited to the extent provided for in articles ~~16 6.4~~ and ~~18 6.7~~; however, if the carrier and shipper expressly have agreed that the goods will be carried under deck, the carrier is not entitled to limit its liability for any loss of or damage to the goods that exclusively resulted from their carriage on deck.

CHAPTER 7. OBLIGATIONS OF THE SHIPPERArticle 25.

7.1—[Subject to the provisions of the contract of carriage,]<sup>114</sup> the shipper shall deliver the goods ready for carriage ~~and~~<sup>115</sup> in such condition that they will

<sup>113</sup> Further to paragraph 80 of A/CN.9/525, the Working Group decided to retain the structure and content of paragraph 6.6 (now article 24) for continuation of the discussion at a later stage. The Working Group may wish to note that this article depends heavily on the definition of “container” in article 1(s).

<sup>114</sup> As noted in paragraph 148 of A/CN.9/510, the Working Group agreed to place the phrase “Subject to the provisions of the contract of carriage” in square brackets pending further consultations and discussions on the scope of the obligation of the carrier and the extent to which it was subject to freedom of contract.

<sup>115</sup> Paragraphs 145 and 148 of A/CN.9/510 noted the Working Group’s agreement to remove the word “and”.

withstand the intended carriage, including their loading, handling, stowage, lashing and securing, and discharge, and that they will not cause injury or damage. In the event the goods are delivered in or on a container or trailer packed by the shipper, the shipper must stow, lash and secure the goods in or on the container or trailer in such a way that the goods will withstand the intended carriage, including loading, handling and discharge of the container or trailer, and that they will not cause injury or damage.<sup>116</sup>

Article 26.

~~7.2~~—The carrier shall provide to the shipper, on its request, such information as is within the carrier's knowledge and instructions that are reasonably necessary or of importance to the shipper in order to comply with its obligations under article ~~25~~ ~~7.1~~.<sup>117</sup>

Article 27.

~~7.3~~—The shipper shall provide to the carrier the information, instructions, and documents that are reasonably necessary for:

(a) the handling and carriage of the goods, including precautions to be taken by the carrier or a performing party;

(b) compliance with rules, regulations, and other requirements of authorities in connection with the intended carriage, including filings, applications, and licences relating to the goods;

(c) the compilation of the contract particulars and the issuance of the transport documents or electronic records, including the particulars referred to in article ~~34(1)~~ ~~8.2.1~~(b) and (c), the name of the party to be identified as the shipper in the contract particulars, and the name of the consignee or order, unless the shipper may reasonably assume that such information is already known to the carrier.<sup>118</sup>

<sup>116</sup> The suggestion in paragraph 148 of A/CN.9/510 to prepare alternative wording based on articles 12, 13 and 17 of the Hamburg Rules was noted by the Working Group.

<sup>117</sup> As noted in paragraph 151 of A/CN.9/510, some doubts were expressed as to whether the draft provision, which focused on the duties of the carrier, was properly placed in the chapter covering the obligations of the shipper. However, it was considered that, in view of the close link between draft article 7.2 (now, article 26) and the other provisions of draft chapter 7 (now, articles 25-32), the placing of the draft provision was not necessarily inappropriate. Subject to the other observations expressed in paragraphs 149 to 151 of A/CN.9/510, the Working Group decided to retain the draft provision with a view to considering its details at a future session (paragraph 152 of A/CN.9/510).

<sup>118</sup> As noted in paragraph 153 of A/CN.9/510, the Working Group approved the text of paragraph 7.3 (now article 27) as a sound basis for continuation of the discussion at a later stage.



Article 28.

7.4—The information, instructions, and documents that the shipper and the carrier provide to each other under articles 26 7.2 and 27 7.3 must be given in a timely manner, and be accurate and complete.<sup>119</sup>

Article 29.Variant A<sup>120</sup>

[7.5—The shipper and the carrier are liable<sup>121</sup> to each other, the consignee, and the controlling party for any loss or damage caused by either party's failure to comply with its respective obligations under articles 26 7.2, 27 7.3, and 28 7.4.]<sup>122</sup>

Variant B

1. The shipper is liable to the carrier, the consignee and the controlling party for any loss or damage [or injury] caused by its failure to comply with its obligations under articles 27 and 28.

2. The carrier is liable to the shipper, the consignee and the controlling party for any loss or damage [or injury] caused by its failure to comply with its obligations under articles 26 and 28.

3. When loss or damage [or injury] is caused jointly by the failure of the shipper and of the carrier to comply with their respective obligations, the shipper and the carrier shall be jointly liable to the consignee or the controlling party for any such loss or damage [or injury].

<sup>119</sup> As noted in paragraph 154 of A/CN.9/510, the Working Group agreed that the text should be retained for further consideration.

<sup>120</sup> Variant A of article 29 is based on the original text of the draft instrument.

<sup>121</sup> As noted in paragraph 156 of A/CN.9/510, a concern was raised that the type of liability established by paragraph 7.5 (now paragraph 1) was inappropriate given that the obligations set out in paragraphs 7.2, 7.3 and 7.4 (now, articles 26, 27 and 28) were not absolute and involved subjective judgements. Imposing strict liability for failure to comply with what were described as flexible and imprecise obligations seemed excessive to some delegations. It was also stated that as currently drafted, the provision was ambiguous and that it was not clear what its effect would be either as to liability to a consignee or a controlling party or as to whether a carrier would be liable to a consignee for the shipper's failure to provide adequate particulars and vice versa.

<sup>122</sup> Other concerns expressed in paragraph 157 A/CN.9/510 were that the provision did not accommodate the situation where both the shipper and the carrier were concurrently liable by allowing for shared liability, and that the provision was ambiguous in that it was not clear what was meant by "loss or damage", when, for example, compared to paragraph 7.6 (now, article 30) which referred to "loss damage or injury". Paragraph 158 of A/CN.9/510 noted that the Working Group concluded that paragraph 7.5 (now article 29) should be placed between square brackets, pending its re-examination in the light of the concerns and suggestions noted in paragraphs 156 and 157. The Secretariat was requested to prepare a revised draft, with possible alternative texts to take account of the suggestions made. At the close of the discussion, the Working Group generally agreed that in revising the draft provision, due consideration should be given to the fact that the information referred to in paragraph 7.5 (now article 29) might be communicated by way of electronic messages, i.e., fed into an electronic communication system and replicated with or without change in the transmission process. In view of the comments made, the alternative texts in Variant B have been prepared.

Article 30.Variant A<sup>123</sup>

~~7.6~~—The shipper is liable to the carrier for any loss, damage, or injury caused by the goods and for a breach of its obligations under article ~~25~~ ~~7.1~~, unless the shipper proves that such loss or damage was caused by events or through circumstances that a diligent shipper could not avoid or the consequences of which a diligent shipper was unable to prevent.

Variant B

A shipper is not [responsible][liable] for loss or damage sustained by the carrier or a ship from any cause without the act, fault or neglect of the shipper[, its agents or servants].<sup>124</sup>

Variant C

The shipper is liable to the carrier for any loss, damage or injury caused by the goods and for a breach of its obligations under article 25 unless the shipper proves it did not cause or contribute to the loss or damage.<sup>125</sup>

Article 31.

~~7.7~~—If a person identified as "shipper" in the contract particulars, although not the shipper as defined in article ~~1(d)~~ ~~4.19~~, accepts the transport document or electronic record, then such person is (a) subject to the responsibilities and liabilities imposed on the shipper under this chapter and under article ~~57~~ ~~4.5~~, and (b) entitled to the shipper's rights and immunities provided by this chapter and by chapter 13.

Article 32.

~~7.8~~—The shipper ~~is~~ shall be responsible for the acts and omissions of any person to which it has delegated the performance of any of its responsibilities under this chapter, including its sub-contractors, employees, agents, and any other persons who act, either directly or indirectly, at its request, or under its supervision or control, as if such acts or omissions were its own. Responsibility is imposed on the shipper under this provision only when the act or omission of the person concerned is within the scope of that person's contract, employment, or agency.<sup>126</sup>

<sup>123</sup> Variant A of article 30 is based on the original text of the draft instrument.

<sup>124</sup> As noted in paragraphs 161 and 170 of A/CN.9/510, it was agreed that this alternative text appear along with the original text of paragraph 7.6 (now Variant A) so that both texts could be considered again at a future session of the Working Group. Paragraph 166 of A/CN.9/510 also noted that it might be necessary to delete the reference in this alternative text to "agents or servants" of the shipper, as the matter might be dealt with in paragraph 7.8 (now article 32).

<sup>125</sup> This alternative is intended to mirror the language used in Variant C for articles 14(1) and (2). The Working Group may wish to consider mirror language for this provision based on which alternative for articles 14(1) and (2) it adopts.

<sup>126</sup> As noted in paragraphs 169 and 170 of A/CN.9/510, the Working Group agreed that paragraph 7.8 (now article 32) was a basis on which to continue discussions whilst keeping in mind the various concerns that had been expressed as to its current wording. At the close of the discussion, it was suggested that paragraph 7.8 (now article 32) should be narrowed so as to apply only to shipper obligations that were delegable rather than those obligations that were non-delegable. It was agreed that the text in paragraph 7.8 (now article 32) should be retained

## CHAPTER 8. TRANSPORT DOCUMENTS AND ELECTRONIC RECORDS

### Article 33.8.1 Issuance of the transport document or the electronic record

Upon delivery of the goods to ~~a~~ the carrier or performing party

(a) ~~(i)~~ the consignor is entitled to obtain a transport document or, if the carrier so agrees, an electronic record evidencing the carrier's or performing party's receipt of the goods;

(b) ~~(ii)~~ the shipper or, if the shipper so indicates to the carrier, the person referred to in article ~~31 7.7~~, is entitled to obtain from the carrier an appropriate negotiable transport document, unless the shipper and the carrier, expressly or impliedly, have agreed not to use a negotiable transport document, or it is the custom, usage, or practice in the trade not to use one. If pursuant to article ~~3 2.1~~ the carrier and the shipper have agreed to the use of an electronic record, the shipper is entitled to obtain from the carrier a negotiable electronic record unless they have agreed not to use a negotiable electronic record or it is the custom, usage or practice in the trade not to use one.<sup>127</sup>

### Article 34. 8.2 Contract particulars

~~1. 8.2.1~~ The contract particulars in the document or electronic record referred to in article ~~33 8.1~~ must include

(a) a description of the goods;

(b) the leading marks necessary for identification of the goods as furnished by the shipper before the carrier or a performing party receives the goods;

(c)

(i) the number of packages, the number of pieces, or the quantity, as furnished by the shipper before the carrier or a performing party receives the goods<sup>128</sup> and

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along with the proposal set out at paragraph 161 of A/CN.9/510 as an alternative for the current text of paragraph 7.6 (now article 30) so that both texts could be considered again at a future session of the Working Group.

<sup>127</sup> As noted in paragraph 25 of A/CN.9/526, the Working Group found the substance of paragraph 8.1 (now article 33) to be generally acceptable. In addition, with respect to subparagraph (i) (now paragraph (a)), a suggestion was made that the words "transport document" should be replaced by the word "receipt". While the term "transport document" was generally preferred for reasons of consistency in terminology, it was acknowledged that, since not all transport documents as defined under paragraph 1.20 (now article 1(k)) served the function of evidencing receipt of the goods by the carrier, it was important to make it abundantly clear that, under subparagraph 8.1(i) (now paragraph (a)), the transport document should serve the receipt function. Further, as noted in paragraph 26 of A/CN.9/526, a question was raised as to whether paragraph 8.1 (now article 33) might interfere with various existing practices regarding the use of specific types of transport documents such as "received for shipment" and "shipped on board" bills of lading. It was stated in response that paragraph 8.1 (now article 33) had been drafted broadly to encompass any type of transport document that might be used in practice, including any specific types of bill of lading or even certain types of non-negotiable waybills.

<sup>128</sup> As noted in paragraph 27 of A/CN.9/526 the Working Group agreed that these words be added. As noted in paragraph 28 of A/CN.9/526, a concern was expressed that the addition of this

(ii) the weight as<sup>129</sup> furnished by the shipper before the carrier or a performing party receives the goods;

(d) a statement of the apparent order and condition of the goods at the time the carrier or a performing party receives them for shipment;

(e) the name and address of the carrier; and

(f) the date

(i) on which the carrier or a performing party received the goods, or

(ii) on which the goods were loaded on board the vessel, or

(iii) on which the transport document or electronic record was issued.<sup>130</sup>

~~2. 8.2.2~~The phrase “apparent order and condition of the goods” in ~~article~~ paragraph 1 8.2.1 refers to the order and condition of the goods based on

(a) a reasonable external inspection of the goods as packaged at the time the shipper delivers them to the carrier or a performing party and

(b) any additional inspection that the carrier or a performing party actually performs before issuing the transport document or the electronic record.<sup>131</sup>

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phrase might be read as placing a heavy liability on the shipper, particularly if article 8 (now articles 33 to 40) was to be read in combination with paragraph 7.4 (now article 28). It was pointed out in response that subparagraph 8.2.1 (now paragraph 1) was not to be read as creating any liability for the shipper under draft article 7 (now chapter 7).

<sup>129</sup> The concern was expressed in paragraph 28 of A/CN.9/526 that the words “as furnished by the shipper before the carrier or a performing party receives the goods” might be read as placing a heavy burden on the shipper, and the response that this provision was not intended to create any liability for the shipper. The Working Group may wish to consider replacing the phrase “as furnished by the shipper” with the phrase “if furnished by the shipper”, and that care should be taken with respect to the use of those phrases in each of the relevant provisions.

<sup>130</sup> As noted in paragraph 75 of A/CN.9/526, it was suggested that the Working Group should consider redrafting subparagraph 8.2.1 (now paragraph 1) to include the name and address of the consignee in the contract particulars that must be put into the transport document. See also the suggested changes to subparagraph 10.3.1 (now article 48), *infra*. The Working Group may wish to determine whether the name and address of the consignee belong on a list of mandatory elements. The Working Group may also wish to discuss the sanction for failure to provide mandatory information. Such sanctions may be different according to whether a transport document is negotiable or not.

<sup>131</sup> Paragraph 31 of A/CN.9/526 noted that the Working Group found the substance of subparagraph 8.2.2 (now paragraph 2) to be generally acceptable.

Article 358.2.3 Signature<sup>132</sup>

(a) A transport document shall be signed by the carrier or a person having authority from the carrier.

(b) An electronic record shall be authenticated by the electronic signature of the carrier or a person having authority from the carrier. For the purpose of this provision such electronic signature means data in electronic form included in, or otherwise logically associated with, the electronic record and that is used to identify the signatory in relation to the electronic record and to indicate the carrier's authorization of the electronic record.<sup>133</sup>

Article 36.8.4 Deficiencies in the contract particulars<sup>134</sup>1.8.2.4 ~~Omission of required contents from the contract particulars~~

The absence of one or more of the contract particulars referred to in article ~~34(1) 8.2.1~~, or the inaccuracy of one or more of those particulars, does not of itself affect the legal character or validity of the transport document or of the electronic record.<sup>135</sup>

2.8.4.1 ~~Date~~

If the contract particulars include the date but fail to indicate the significance thereof, then the date is considered to be:

(a) if the contract particulars indicate that the goods have been loaded on board a vessel, the date on which all of the goods indicated in the transport document or electronic record were loaded on board the vessel; or

(b) if the contract particulars do not indicate that the goods have been loaded on board a vessel, the date on which the carrier or a performing party received the goods.<sup>136</sup>

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<sup>132</sup> The Working Group may wish to consider whether "signature" should be defined as, for example, in article 14(3) of the Hamburg Rules, particularly in light of modern practice.

<sup>133</sup> As noted in paragraph 32 of A/CN.9/526, the Working Group agreed that the substance of subparagraph 8.2.3 (now article 35) was generally acceptable, but that the provision might need to be further discussed at a later stage with a view to verifying its consistency with the UNCITRAL Model Law on Electronic Signatures 2001. In redrafting, it may be useful to bear in mind articles 14(2) and (3) of the Hamburg Rules.

<sup>134</sup> For improved consistency, this provision has been moved here from its original location.

<sup>135</sup> As noted in paragraph 34 of A/CN.9/526, the Working Group found the substance of subparagraph 8.2.4 (now paragraph 1) to be generally acceptable.

<sup>136</sup> As noted in paragraph 55 of A/CN.9/526, the Working Group found the substance of subparagraph 8.4.1 (now paragraph 2) to be generally acceptable, taking into account the issue raised with respect to electronic records that the terms "transport document or electronic record" are repeated throughout the provisions of chapter 8 of the draft instrument, and that the repetition of this phrase emphasized the distinction between transport documents and electronic records, rather than focusing on the content of the document, as intended in the mandate of the Working Group.

[3. 8.4.2 Failure to identify the carrier

If the contract particulars fail to identify the carrier but indicate that the goods have been loaded on board a named vessel, then the registered owner of the vessel is presumed to be the carrier. The registered owner can defeat this presumption if it proves that the ship was under a bareboat charter at the time of the carriage which transfers contractual responsibility for the carriage of the goods to an identified bareboat charterer. [If the registered owner defeats the presumption that it is the carrier under this article, then the bareboat charterer at the time of the carriage is presumed to be the carrier in the same manner as that in which the registered owner was presumed to be the carrier.]]<sup>137</sup>

~~4. 8.4.3 Apparent order and condition~~

If the contract particulars fail to state the apparent order and condition of the goods at the time the carrier or a performing party receives them from the shipper, the transport document or electronic record is either prima facie or conclusive evidence under article ~~39 8.3.3~~, as the case may be, that the goods were in apparent good order and condition at the time the shipper delivered them to the carrier or a performing party.<sup>138</sup>

Article 37. 8.3 Qualifying the description of the goods in the contract particulars

~~8.3.1 Under the following circumstances, t~~The carrier, if acting in good faith when issuing a transport document or an electronic record, may qualify the information mentioned in article ~~34(1)(a) 8.2.1(a)~~,<sup>139</sup> ~~34(1)(b) 8.2.1(b) or 34(1)(c) 8.2.1(c) with an appropriate clause therein in the circumstances and in the manner set out below in order~~ to indicate that the carrier does not assume responsibility for the accuracy of the information furnished by the shipper:

(a) For non-containerized goods

(i) if the carrier can show that it had no reasonable means of checking the information furnished by the shipper, it may ~~include an appropriate qualifying clause~~ so state in the contract particulars, indicating the information to which it refers, or

(ii) if the carrier reasonably considers the information furnished by the shipper to be inaccurate, it may include a clause providing what it reasonably considers accurate information.

<sup>137</sup> As noted in paragraph 60 of A/CN.9/526, the prevailing view in the Working Group was the subparagraph 8.4.2 (now paragraph 3) identified a serious problem that must be treated in the draft instrument, but that the matter required further study with respect to other means through which to combat the problem, and that the provision as drafted was not yet satisfactory. The Working Group decided to keep subparagraph 8.4.2 (now paragraph 3) in square brackets in the draft instrument, and to discuss it in greater detail at a future date.

<sup>138</sup> As noted in paragraph 61 of A/CN.9/526, the Working Group found the substance of subparagraph 8.4.3 (now paragraph 4) to be generally acceptable.

<sup>139</sup> The addition of a reference to subparagraph 8.2.1(a) (now article 34(1)(a)) was suggested in paragraph 36 of A/CN.9/526.

(b) For goods delivered to the carrier or a performing party in a closed container, unless<sup>140</sup> the carrier or a performing party in fact inspects the goods inside the container or otherwise has actual knowledge of the contents of the container before issuing the transport document, provided, however, that in such case the carrier may include such clause if it reasonably considers the information furnished by the shipper regarding the contents of the container to be inaccurate<sup>141</sup>, the carrier may include an ~~appropriate~~ qualifying clause in the contract particulars with respect to

(i) the leading marks on the goods inside the container, or

(ii) the number of packages, the number of pieces, or the quantity of the goods inside the container.

(c) For goods delivered to the carrier or a performing party in a closed container, the carrier may qualify any statement of the weight of goods or the weight of a container and its contents with an explicit statement that the carrier has not weighed the container if

(i) the carrier can show that neither the carrier nor a performing party weighed the container, and

the shipper and the carrier did not agree prior to the shipment that the container would be weighed and the weight would be included in the contract particulars, or-

(ii) the carrier can show that there was no commercially reasonable means of checking the weight of the container.<sup>142</sup>

<sup>140</sup> The phrase “unless the carrier or a performing party in fact inspects the goods inside the container or otherwise has actual knowledge of the contents of the container before issuing the transport document, provided, however, that in such case the carrier may include such clause if it reasonably considers the information furnished by the shipper regarding the contents of the container to be inaccurate” has been moved to this position in the chapeau from its original position at the end of the paragraph in order to clarify that it is intended to apply to the entire paragraph.

<sup>141</sup> As noted in paragraph 36 of A/CN.9/526, another suggestion was that language along the lines of subparagraph 8.3.1(a)(ii) (now paragraph (a)(ii)) should be included also in subparagraph 8.3.1(b) (now paragraph b) to address the situation where the carrier reasonably considers the information furnished by the shipper regarding the contents of the container to be inaccurate. The Working Group may also wish to note the suggestions made in paragraph 37 of A/CN.9/526 that the carrier who decided to qualify the information mentioned on the transport document should be required to give the reasons for such qualification, that the draft instrument should deal with the situation where the carrier accepted not to qualify the description of the goods, for example not to interfere with a documentary credit, but obtained a guarantee from the shipper. Another suggestion was that, where the carrier acting in bad faith had voluntarily avoided to qualify the information in the contract particulars, such conduct should be sanctioned and no limitation of liability could be invoked by the carrier.

<sup>142</sup> As noted in paragraph 36 of A/CN.9/526, it was suggested that appropriate wording should be added to cover the case where there was no commercially reasonable possibility to weigh the container. The Working Group may wish to note that this subparagraph is intended to align with the provision on the reasonable means of checking, in article 38.

Article 38.3.2 Reasonable means of checking and good faith

For purposes of article ~~37.8.3.1~~:

- (a) a “reasonable means of checking” must be not only physically practicable but also commercially reasonable;
- (b) ~~a~~ the carrier acts in “good faith” when issuing a transport document or an electronic record if
  - (i) the carrier has no actual knowledge that any material statement in the transport document or electronic record is materially false or misleading, and
  - (ii) the carrier has not intentionally failed to determine whether a material statement in the transport document or electronic record is materially false or misleading because it believes that the statement is likely to be false or misleading.
- (c) The burden of proving whether ~~a~~ the carrier acted in good faith when issuing a transport document or an electronic record is on the party claiming that the carrier did not act in good faith.<sup>143</sup>

Article 39.8.3.3 Prima facie and conclusive evidence

Except as otherwise provided in article ~~40.8.3.4~~, a transport document or an electronic record that evidences receipt of the goods is

- (a) prima facie evidence of the carrier’s receipt of the goods as described in the contract particulars; and
- (b) conclusive evidence of the carrier’s receipt of the goods as described in the contract particulars
  - [(i)] if a negotiable transport document or a negotiable electronic record has been transferred to a third party acting in good faith [or
  - (ii) Variant A of paragraph (b)(ii)<sup>144</sup>

if a person acting in good faith has paid value or otherwise altered its position in reliance on the description of the goods in the contract particulars].

Variant B of paragraph (b)(ii)

if no negotiable transport document or no negotiable electronic record has been issued and the consignee has purchased and paid for the goods in reliance on the description of the goods in the contract particulars.]<sup>145</sup>

<sup>143</sup> As noted in paragraph 43 of A/CN.9/526, the Working Group found the substance of subparagraph 8.3.2 (now article 38) to be generally acceptable.

<sup>144</sup> Variant A of paragraph (b)(ii) is based on the original text of the draft instrument.

<sup>145</sup> As noted in paragraph 48 of A/CN.9/526, the prevailing view in the Working Group was to retain subparagraph 8.3.3(b)(ii) (now paragraph (b)(ii)) in square brackets and to request the Secretariat to make the necessary modifications to it with due consideration being given to the views expressed and the suggestions made in paragraphs 45 to 47.



Article 40.8.3.4 Evidentiary effect of qualifying clauses

If the contract particulars include a qualifying clause that complies with the requirements of article ~~37 8.3.1~~, then the transport document will not constitute prima facie or conclusive evidence under article ~~39 8.3.3~~ to the extent that the description of the goods is qualified by the clause.<sup>146</sup>

CHAPTER 9. FREIGHT<sup>147</sup>Article 41.

~~[1. 9.1—~~(a) Freight is earned upon delivery of the goods to the consignee at the time and location mentioned in article ~~7(3) 4.1.3~~, and is payable when it is earned.<sup>148</sup> unless the parties have agreed that the freight is earned, wholly or partly, at an earlier point in time.

<sup>146</sup> As noted in paragraphs 50 to 52 of A/CN.9/526, while some support was expressed for redrafting subparagraph 8.3.4 (now article 40), the prevailing view was that it should be retained in substance for continuation of the discussion at a future session.

The Working Group may also wish to consider the alternative language for subparagraph 8.3.4 (now article 40) suggested in paragraphs 153 and 154 of A/CN.9/WG.III/WP.21:

40(1) “If the contract particulars include a qualifying clause, then the transport document will not constitute prima facie or conclusive evidence under article ~~39 8.3.3~~, to the extent that the description of the goods is qualified by the clause, when the clause is “effective” under paragraph ~~2 8.3.5~~.”

It would then be necessary to add a new article 8.3.5 (perhaps as paragraph 2), which might provide:

2. “A qualifying clause in the contract particulars is effective for the purposes of paragraph ~~1 8.3.4~~ under the following circumstances:

(a) For non-containerized goods, a qualifying clause that complies with the requirements of article ~~37 8.3.1~~ will be effective according to its terms.

(b) For goods shipped in a closed container, a qualifying clause that complies with the requirements of article ~~37 8.3.1~~ will be effective according to its terms if

(i) the carrier or a performing party delivers the container intact and undamaged, except for such damage to the container as was not causally related to any loss of or damage to the goods; and

(ii) there is no evidence that after the carrier or a performing party received the container it was opened prior to delivery, except to the extent that

(1) a container was opened for the purpose of inspection,

(2) the inspection was properly witnessed, and

(3) the container was properly reclosed after the inspection, and was resealed if it had been sealed before the inspection.”

<sup>147</sup> It was said by way of general comment in paragraph 172 of A/CN.9/510, that neither the Hague nor the Hamburg regimes contained provisions on freight and that it was questionable whether the draft instrument would benefit from dealing with this issue. Further reservations were noted in that paragraph as to the inclusion of freight provisions were based on the fact that practices varied widely between different trades. Paragraph 183 of A/CN.9/510 noted that the draft provision should be restructured, with paragraphs 9.1(a) (now article 41(1)) and 9.2(b) (now article 42(2)) being combined in a single provision, paragraph 9.1(b) (now article 41(2)) standing alone and paragraphs 9.2(b) and (c) (now articles 42(2) and (3)) also being combined. It was also provisionally agreed that appropriate clarification should be introduced to limit the application of paragraphs 9.2(b) and (c) (now articles 42(2) and (3)) to cases where specific agreement had been concluded between the parties.

<sup>148</sup> As noted in paragraph 174 of A/CN.9/510, there was general agreement that the principle of freedom of contract should apply to determining when the payment of freight was earned as well as when the payment of freight became due. See also *ibid*, paragraph 183 of A/CN.9/510.

~~2.~~ (b) Unless otherwise agreed, no freight becomes due for any goods that are lost before the freight for those goods is earned.

Article 42.

Variant A<sup>149</sup>

~~1.9.2~~—(a) Freight is payable when it is earned, unless the parties have agreed that the freight is payable, wholly or partly, at an earlier or later point in time.

~~2.~~ (b) If subsequent to the moment at which the freight has been earned the goods are lost, damaged, or otherwise not delivered to the consignee in accordance with the provisions of the contract of carriage, freight shall remain payable irrespective of the cause of such loss, damage or failure in delivery.

~~3.~~ (c) Unless otherwise agreed, payment of freight is not subject to set-off, deduction or discount on the grounds of any counterclaim that the shipper or consignee may have against the carrier, [the indebtedness or the amount of which has not yet been agreed or established].

Variant B<sup>150</sup>

If subsequent to the moment at which the freight has been earned the goods are lost, damaged, or otherwise not delivered to the consignee in accordance with the provisions of the contract of carriage, unless otherwise agreed, freight shall remain payable irrespective of the cause of such loss, damage or failure in delivery, nor is payment of freight subject to set-off, deduction or discount on the grounds of any counterclaim that the shipper or consignee may have against the carrier [the indebtedness of which has not yet been agreed or established]<sup>151</sup>.

Article 43.

~~1.9.3~~—(a) Unless otherwise agreed, the shipper is liable to pay the freight and other charges incidental to the carriage of the goods.

~~2.~~ (b) If the contract of carriage provides that the liability of the shipper or any other person identified in the contract particulars as the shipper will cease, wholly or partly, upon a certain event or after a certain point of time, such cessation is not valid:

(a) (i) with respect to any liability under chapter 7 of the shipper or a person mentioned in article ~~31.7.7~~; or

(b) (ii) with respect to any amounts payable to the carrier under the contract of carriage, except to the extent that the carrier has adequate security pursuant to article ~~45.9.5~~ or otherwise for the payment of such amounts.

<sup>149</sup> Variant A of article 42 is based on the original text of the draft instrument.

<sup>150</sup> See *supra* note 147, paragraph 183 of A/CN.9/510.

<sup>151</sup> As noted in paragraph 182 of A/CN.9/510, wide support was expressed for including in the draft provision the words currently between square brackets, “the indebtedness or the amount of which has not yet been agreed or established”.

~~(c) (iii)~~ to the extent that it conflicts with ~~the provisions of article 62~~  
12.4.<sup>152</sup>

#### Article 44.

~~1. 9.4~~ (a) If the contract particulars in a negotiable<sup>153</sup> transport document or a[n] negotiable<sup>154</sup> electronic record contain the statement “freight prepaid” or a statement of a similar nature, then neither the holder nor the consignee, ~~is shall be~~ liable for the payment of the freight. This provision ~~does shall~~ not apply if the holder or the consignee is also the shipper.

If the contract particulars in a non-negotiable transport document or in a non-negotiable electronic record contain a statement “freight prepaid” or a statement of a similar nature, then it shall be presumed that the shipper is liable for the payment of the freight.<sup>155</sup>

2. (b) Variant A of paragraph 2<sup>156</sup>

If the contract particulars in a transport document or an electronic record contain the statement “freight collect” or a statement of similar nature, [such a statement puts the consignee on notice that it may be liable for the payment of the freight][the right of the consignee to obtain delivery of the goods is conditional on the payment of freight].<sup>157</sup>

#### Variant B of paragraph 2

If the contract particulars in a transport document or an electronic record contain the statement “freight collect”, or a statement of a similar nature, that constitutes a provision that, in addition to the shipper, any holder or consignee who takes delivery of the goods or exercises any right in relation to the goods will thereupon become liable for the freight.<sup>158</sup>

<sup>152</sup> As noted in paragraph 189 of A/CN.9/510, the Working Group took note of the criticism of provision 9.3(b) (now paragraph 2) (noted in paragraphs 185 to 188 of A/CN.9/510) and decided to postpone its decision on the matter until the issue, including the practical context in which the provision was to operate, was further studied.

<sup>153</sup> Paragraph 110 of A/CN.9/525 noted the suggestion that the declaration in subparagraph 9.4(a) (now paragraph 1) was too radical in freeing the holder and consignee of any responsibility for the payment of freight, and instead that it would be better to create a presumption of the absence of a debt for freight. However, the alternative view was expressed that subparagraph 9.4(a) (now paragraph 1) should not create a presumption that the freight had been prepaid. A possible answer to this suggestion reported in paragraph 110 would be to draw a distinction between negotiable and non-negotiable transport documents or electronic records.

<sup>154</sup> Ibid.

<sup>155</sup> See *supra* note 153.

<sup>156</sup> Variant A of paragraph 2 is based on the original text of the draft instrument.

<sup>157</sup> See *supra* note 153.

<sup>158</sup> As noted in paragraph 111 of A/CN.9/525, it was said that draft articles 12.2.2 and 12.2.4 (now articles 60(2) and 62) were intimately linked with subparagraph 9.4(b) (now paragraph 2), and that consideration of these provisions should be undertaken at the same time. It was suggested that if the consignee took any responsibility for the delivery of the goods, it should also be responsible for the freight. At the same time, it was noted that subparagraph 9.4(b) (now paragraph 2) could serve to provide information or a warning that freight was still payable.

Article 45.

~~1. 9.5~~—(a) [Notwithstanding any agreement to the contrary,] if and to the extent that under national law applicable to the contract of carriage the consignee is liable for the payments referred to below, the carrier is entitled to retain the goods until payment of

(a) ~~(i)~~ freight, deadfreight, demurrage, damages for detention and all other reimbursable costs incurred by the carrier in relation to the goods,

(b) ~~(ii)~~ any damages due to the carrier under the contract of carriage,

(c) ~~(iii)~~ any contribution in general average due to the carrier relating to the goods

has been effected, or adequate security for such payment has been provided.

2. ~~(b)~~ If the payment as referred to in paragraph 1 ~~(a)~~ of this article is not, or is not fully, effected, the carrier is entitled to sell the goods (according to the procedure, if any, as provided for in the applicable national law) and to satisfy the amounts payable to it (including the costs of such recourse) from the proceeds of such sale. Any balance remaining from the proceeds of such sale shall be made available to the consignee.<sup>159</sup>

CHAPTER 10. DELIVERY TO THE CONSIGNEEArticle 46.

~~10.1~~ When the goods have arrived at their destination, the consignee [that exercises any of its rights under the contract of carriage]<sup>160</sup> shall accept delivery of the goods at the time and location mentioned in article ~~7(3)~~ ~~4.1.3~~. [If the consignee, in breach of this obligation, leaves the goods in the custody of the carrier or the performing party, the carrier or performing party will act in respect of the goods as an agent of the consignee, but without any liability for loss or damage to these goods, unless the loss or damage results from a personal act or omission of the carrier or of the

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However, it was suggested that the payment of freight should be a condition for the consignee to obtain delivery of the goods, rather than an obligation. It was further noted that subparagraph 9.4(b) (now paragraph 2) should focus on the payment of freight in fact, rather than on who should bear the obligation for the unpaid freight. As noted in paragraph 112 of A/CN.9/525, one proposal to remedy the perceived problem was to replace the words “such a statement puts the consignee on notice that it may be liable for the payment of the freight” with the words, “the payment of freight is a condition for the exercise by the consignee of the right to obtain delivery of the goods.” Paragraph 113 of A/CN.9/525 noted the alternative suggestion used in order to overcome the problems outlined in paragraphs 111 and 112.

<sup>159</sup> Although the text of paragraph 9.5 (now article 45) was heavily criticised in paragraphs 115 to 122 of A/CN.9/525, it does not appear that the Secretariat has been requested to prepare a new draft or an alternative draft. Paragraph 123 of A/CN.9/525 noted that the Working Group decided that paragraph 9.5 (now article 45) should be retained in the draft instrument for continuation of the discussion at a later stage.

<sup>160</sup> As noted in paragraph 67 of A/CN.9/526, a preference was expressed for the obligation to accept delivery not to be made dependent upon the exercise of any rights by the consignee, but rather that it be unconditional.

performing party]<sup>161</sup> done with the intent to cause such loss or damage, or recklessly, with the knowledge that such loss or damage probably would result.<sup>162</sup>

Article 47.

~~10.2~~ On request of the carrier or the performing party that delivers the goods, the consignee shall confirm delivery of the goods by the carrier or the performing party in the manner that is customary at the place of destination.<sup>163</sup>

Article 48.

~~10.3.1~~ If no negotiable transport document or no negotiable electronic record has been issued:

(a) ~~(i)~~ If the name and address of the consignee is not mentioned in the contract particulars the controlling party shall advise the carrier therof, prior to or upon the arrival of the goods at the place of destination; ~~of the name of the consignee.~~<sup>164</sup>

(b) ~~(ii)~~ Variant A of paragraph (b)<sup>165</sup>

The carrier shall deliver the goods at the time and location mentioned in article ~~7(3)~~ 4.1.3 to the consignee upon the consignee's production of proper identification;<sup>166</sup>

Variant B of paragraph (b)

As a requisite for delivery, the consignee shall produce proper identification.

Variant C of paragraph (b)

The carrier may refuse delivery if the consignee does not produce proper identification.

<sup>161</sup> As noted in paragraph 70 of A/CN.9/526, it was suggested that the concern that performing parties could become liable through the act or omission of the carrier pursuant to the second sentence of paragraph 10.1 (now article 46) could be clarified with the addition of the phrase "or of the performing party" after the phrase "personal act or omission of the carrier".

<sup>162</sup> As noted in paragraph 67 of A/CN.9/526, suggestions were made that paragraph 10.1 (now article 46) and 10.4 (now articles 50, 51 and 52) could be merged, or that to reduce the confusion caused by the interplay of paragraphs 10.1 (now article 46) and 10.4 (now articles 50, 51, and 52), the second sentence of paragraph 10.1 (now article 46) could be deleted, and paragraph 10.4 (now articles 50, 51, and 52) could be left to stand on its own. The second of these alternatives has been chosen, and the last sentence has been placed in square brackets.

<sup>163</sup> As noted in paragraph 73 of A/CN.9/526, the Working Group found the substance of paragraph 10.2 (now article 47) to be generally acceptable.

<sup>164</sup> As noted in paragraph 77 of A/CN.9/526, the Working Group found the principles embodied in subparagraph 10.3.1 (now article 48) to be generally acceptable. The Working Group requested the Secretariat to prepare a revised draft with due consideration being given to the views expressed and to the suggestions made.

The suggestion made in paragraph 75 of A/CN.9/526, regarding the identity of the consignee has been incorporated in the text. See also the note to subparagraph 8.2.1 (now article 34(1)), *supra*, note 130.

<sup>165</sup> Variant A of paragraph (b) is based on the original text of the draft instrument.

<sup>166</sup> The suggestion made in paragraph 76 of A/CN.9/526 that subparagraph 10.3.1(ii) (now paragraph (b)) should be revised by referring to the carrier's right to refuse delivery without the production of proper identification, but that this should not be made an obligation of the carrier has been incorporated in the text of both Variant B and C.

~~(c) (iii)~~ If the consignee does not claim delivery of the goods from the carrier after their arrival at the place of destination, the carrier shall advise the controlling party or, if it, after reasonable effort, is unable to identify the controlling party, the shipper, accordingly. In such event such controlling party or shipper shall give instructions in respect of the delivery of the goods. If the carrier is unable, after reasonable effort, to identify and find the controlling party or the shipper, then the person mentioned in article ~~31 7.7~~ shall be deemed to be the shipper for purposes of this paragraph.<sup>167</sup>

#### Article 49.

~~10.3.2~~ If a negotiable transport document or a negotiable electronic record has been issued, the following provisions shall apply:

(a) (i) Without prejudice to ~~the provisions of article 46 10.1~~ the holder of a negotiable transport document is entitled to claim delivery of the goods from the carrier after they have arrived at the place of destination, in which event the carrier shall deliver the goods at the time and location mentioned in article ~~7(3) 4.1.3~~ to such holder upon surrender of the negotiable transport document. In the event that more than one original of the negotiable transport document has been issued, the surrender of one original will suffice and the other originals cease to have any effect or validity.

(ii) Without prejudice to ~~the provisions of article 46 10.1~~ the holder of a negotiable electronic record is entitled to claim delivery of the goods from the carrier after they have arrived at the place of destination, in which event the carrier shall deliver the goods at the time and location mentioned in article ~~7(3) 4.1.3~~ to such holder if it demonstrates in accordance with the rules of procedure mentioned in article ~~6.2.4~~ that it is the holder of the electronic record. Upon such delivery, the electronic record ceases to have any effect or validity.<sup>168</sup>

(b) If the holder does not claim delivery of the goods from the carrier after their arrival at the place of destination, the carrier shall advise accordingly the controlling party or, if, after reasonable effort, it is unable to identify or find the controlling party, the shipper. In such event the controlling party or shipper shall give the carrier instructions in respect of the delivery of the goods. If the carrier is unable, after reasonable effort, to identify and find the controlling party or the shipper, then the person mentioned in article ~~31 7.7~~ is shall be deemed to be the shipper for purposes of this paragraph.<sup>169</sup>

<sup>167</sup> As noted in paragraph 82 of A/CN.9/526, a suggestion was made during the consideration of subparagraph 10.3.2(b) (now article 49(b)) that the principles expressed therein should also apply in cases where no negotiable instrument had been issued. A provision to this effect has been added as subparagraph 10.3.1(iii) (now paragraph (c)).

<sup>168</sup> Subject to the note of caution raised in paragraph 80 of A/CN.9/526, that the Working Group would have to carefully examine the balance of different rights and obligations, and their consequences, amongst the parties, in order to strike the right level and reach a workable solution, as noted in paragraph 81 of A/CN.9/526, the Working Group found the substance of subparagraphs 10.3.2(a)(i) and (ii) (now paragraphs (a)(i) and (ii)) to be generally acceptable.

<sup>169</sup> The first suggestion made in paragraph 82 of A/CN.9/526, that the carrier should have the obligation of accepting the negotiable transport document and of notifying the controlling party if the holder of the document did not claim delivery. These concerns appear to be already addressed by the text of subparagraph 10.3.2(b) (now paragraph (b)). The second suggestion in

(c) [Notwithstanding the provision of paragraph (d) of this article,<sup>170</sup> ~~the~~ carrier that delivers the goods upon instruction of the controlling party or the shipper in accordance with paragraph (b) of this article ~~is~~ shall be discharged from its obligation to deliver the goods under the contract of carriage [to the holder], irrespective of whether the negotiable transport document has been surrendered to it, or the person claiming delivery under a negotiable electronic record has demonstrated, in accordance with the rules of procedure referred to in article ~~6.2.4~~, that it is the holder.

(d) [Except as provided in paragraph (c) above]<sup>171</sup> If the delivery of the goods by the carrier at the place of destination takes place without the negotiable transport document being surrendered to the carrier or without the demonstration referred to in paragraph (a) (ii) above, a holder who becomes a holder after the carrier has delivered the goods to the consignee or to a person entitled to these goods pursuant to any contractual or other arrangement other than the contract of carriage will only acquire rights [against the carrier]<sup>172</sup> under the contract of carriage if the passing of the negotiable transport document or negotiable electronic record was effected in pursuance of contractual or other arrangements made before such delivery of the goods, unless such holder at the time it became holder did not have or could not reasonably have had knowledge of such delivery. [This paragraph does not apply where the goods are delivered by the carrier pursuant to paragraph (c) above.]<sup>173</sup>

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paragraph 82 of A/CN.9/526 that this subparagraph should set out the consequences for the carrier when it failed to notify the controlling party or the shipper or the deemed shipper has met with objections and, therefore, has not been included in the revised text.

<sup>170</sup> As noted in paragraph 83 of A/CN.9/526, it was suggested that it was unclear how subparagraphs 10.3.2(c) and (d) (now paragraphs (c) and (d)) worked together, since the holder in good faith in the latter provision acquired some legal protection, but the holder's legal position was unclear. It was requested that the drafting in this regard be clarified. It should be noted that a link between subparagraphs 10.3.2(c) and (d) (now paragraphs (c) and (d)) already exists, since subparagraph 10.3.2(c) (now paragraph (c)) starts with the words, "Notwithstanding the provision of paragraph (d) of this article". This is a technique used in other provisions of the draft instrument, such as paragraphs 5.3 (now article 12) and 6.1.3 (now article 14(2)). Other alternatives are possible, for example, to start subparagraph (d) with the words "Except as provided" or to add at the end of that paragraph a new sentence reading "The provisions of this paragraph (d) do not apply where the goods are delivered by the carrier pursuant to paragraph (c) of this article." The various alternatives are provisionally inserted in square brackets.

<sup>171</sup> As noted in paragraph 83 of A/CN.9/526. See *supra* note 170.

<sup>172</sup> Various comments and explanations with respect to subparagraph 10.3.2(d) (now paragraph (d)) are noted in paragraphs 83 to 88 of A/CN.9/526. The first concern expressed in paragraph 88 of A/CN.9/526 is that the rights of the holder who was in possession of the negotiable transport document after delivery had been effected should be more precisely established. It is thought that a solution might be to indicate in subparagraph (d) that the rights are acquired against the carrier, and this language has been inserted into the provision. It could also be added that such rights arise from the failure of the carrier to fulfil its obligation under paragraph 5.1 (now article 10), but this may not be advisable. In addition, attention is drawn to the new much wider provision suggested for paragraph 13.1 (now article 59), *infra*. The second concern expressed in paragraph 88 of A/CN.9/526 that there was a lack of certainty regarding the phrase "could not reasonably have had knowledge of such delivery" has not specifically been addressed.

<sup>173</sup> As noted in paragraph 83 of A/CN.9/526. See *supra* note 170.

(e) If the controlling party or the shipper does not give the carrier adequate instructions as to the delivery of the goods [or in cases where the controlling party or the shipper cannot be found]<sup>174</sup>, the carrier is entitled, without prejudice to any other remedies that ~~the~~ carrier may have against such controlling party or shipper, to exercise its rights under articles 50, 51 and 52 ~~10.4~~.

Article 50.

1. ~~10.4.1~~ (a) If the goods have arrived at the place of destination and

(a) (i) the goods are not actually taken over by the consignee at the time and location mentioned in article 7(3) ~~4.1.3~~ [and no express or implied contract has been concluded between the carrier or the performing party and the consignee that succeeds to the contract of carriage]<sup>175</sup>; or

(b) (ii) the carrier is not allowed under applicable law or regulations to deliver the goods to the consignee,

then the carrier is entitled to exercise the rights and remedies mentioned in paragraph 2 ~~(b)~~.

2. (b) Under the circumstances specified in paragraph 1 ~~(a)~~, the carrier is entitled, at the risk and account and at the expense<sup>176</sup> of the person entitled to the goods, to exercise some or all of the following rights and remedies:

(a) (i) to store the goods at any suitable place;

(b) (ii) to unpack the goods if they are packed in containers, or to act otherwise in respect of the goods as, in the opinion of the carrier, circumstances reasonably may require; or

(c) (iii) to cause the goods to be sold in accordance with the practices, or the requirements under the law or regulations, of the place where the goods are located at the time.

3. — (e) If the goods are sold under paragraph 2(c) ~~(b)(iii)~~, the carrier may deduct from the proceeds of the sale the amount necessary to

(a) (i) pay or reimburse any costs incurred in respect of the goods;  
and

<sup>174</sup> This addition has been made on the basis of the suggestion in paragraph 89 of A/CN.9/526 that subparagraph 10.3.2(e) (now paragraph (e)) should be aligned with subparagraph 10.3.2(b) (now paragraph (b)) through the insertion of this phrase.

<sup>175</sup> As noted in paragraph 92 of A/CN.9/526, concern was expressed with respect to the phrase “no express or implied contract has been concluded between the carrier or the performing party and the consignee that succeeds to the contract of carriage” as confusing, since it could be seen to concern a contract for warehousing if it is one that “succeeds to the contract of carriage”, and the notion of “express or implied” was also said to be difficult to understand. The phrase has thus been placed in square brackets for possible future deletion.

<sup>176</sup> As noted in paragraph 97 of A/CN.9/526, concern was expressed that when the carrier exercised its rights under subparagraph 10.4.1 (now article 50) it could result in costs in addition to those arising from loss or damage, and that the value of the goods might not in some cases cover the costs incurred. The addition of the phrase “and at the expense” adding in subparagraph 10.4.1(b) (now paragraph 2) is intended to meet these concerns.



~~(b) (ii)~~ pay or reimburse the carrier any other amounts that are referred to in article ~~45(1) 9.5(a)~~ and that are due to the carrier.

Subject to these deductions, the carrier shall hold the proceeds of the sale for the benefit of the person entitled to the goods.

#### Article 51.

~~10.4.2~~ The carrier is only allowed to exercise the right referred to in article ~~46 10.4.1~~ after it has given a reasonable advance<sup>177</sup> notice to the person stated in the contract particulars as the person to be notified of the arrival of the goods at the place of destination, if any, or to the consignee, or otherwise to the controlling party or the shipper that the goods have arrived at the place of destination.

#### Article 52.

~~10.4.3~~ When exercising its rights referred to in article ~~50(2) 10.4.1(b)~~, the carrier or performing party ~~acts as an agent of the person entitled to the goods, but without any liability shall be liable~~<sup>178</sup> for loss of or damage to these goods, ~~unless only if~~ the loss or damage results from ~~[a personal an~~ an act or omission of the carrier or of the performing party done with the intent to cause such loss or damage, or recklessly, with the knowledge that such loss or damage probably would result]<sup>179</sup>.

### CHAPTER 11. RIGHT OF CONTROL

#### Article 53.

~~11.1~~ [The right of control of the goods [means][includes][comprises] the right to agree with the carrier to a variation of the contract of carriage and the right<sup>180</sup> under

<sup>177</sup> As noted in paragraph 93 of A/CN.9/526, the question was raised why only notice was necessary and why the carrier did not have to wait for a response or reaction from the person receiving the notice before exercising its rights. The addition of the phrase “a reasonable advance” before the word “notice” in subparagraph 10.4.2 (now article 51) is intended to meet these concerns.

<sup>178</sup> The concern expressed in paragraph 94 of A/CN.9/526 that the wording of subparagraph 10.4.3 (now article 52) could be seen to suggest that the act or omission of the carrier could result in the liability of the performing party. The deletion of the words “acts as an agent of the person entitled to the goods but without any liability” and the addition of the words “shall only be liable”, is intended to meet this concern.

<sup>179</sup> As noted in paragraph 94 of A/CN.9/526, it was suggested that the phrase “or of the performing party” be added after the phrase “personal act or omission of the carrier”, and that the word “personal” be deleted. Both of these suggestions have been adopted in the text. The suggestion in paragraph 96 of A/CN.9/526 that subparagraphs 10.4.3 (now article 52) and 10.4.1 (now article 50) had similarities in their content that should be reflected in their language was not thought to have received enough support for reflection in the text.

<sup>180</sup> The concerns raised in paragraph 103 of A/CN.9/526 that subparagraph (iv) (now paragraph (d)) should be deleted to preserve the unilateral nature of any instruction that might be given to the carrier by the controlling party, as opposed to any modification regarding the terms of the contract of carriage, which would require the mutual agreement of the parties to that contract. In response, it was suggested that this provision served a useful purpose in the definition of the right of control in that it made it clear that the controlling party should be regarded as the counterpart of the carrier during the voyage. These concerns could be met by placing subparagraph (iv) (now paragraph (d)) in square brackets, and by inserting a phrase such as that in subparagraph (iv) (now paragraph (d)) in the chapeau of paragraph 11.1 (now article 53). It should also be noted that the first sentence of the chapeau will have to be adjusted if a definition

the contract of carriage to give the carrier instructions in respect of these goods during the period of its responsibility as stated in article ~~7(1) 4.1.1.~~<sup>181</sup> Such right to give the carrier instructions comprises rights to:

(a) ~~(i)~~ give or modify instructions in respect of the goods [that do not constitute a variation of the contract of carriage]<sup>182</sup>;

(b) ~~(ii)~~ demand delivery of the goods before their arrival at the place of destination;

(c) ~~(iii)~~ replace the consignee by any other person including the controlling party;

~~(d) (iv)~~ agree with the carrier to a variation of the contract of carriage.<sup>183</sup>

#### Article 54.

~~1. 11.2~~—(a) When no negotiable transport document or no negotiable electronic record is issued, the following rules apply:

(a) ~~(i)~~ The shipper is the controlling party unless the shipper [and consignee agree that another person is to be the controlling party and the shipper so notifies the carrier. The shipper and consignee may agree that the consignee is the controlling party] [designates the consignee or another person as the controlling party]<sup>184</sup>.

(b) ~~(ii)~~—The controlling party is entitled to transfer the right of control to another person, upon which transfer the transferor loses its right of control. The transferor [or the transferee]<sup>185</sup> shall notify the carrier of such transfer.

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based upon it is included in article 1(g).

<sup>181</sup> The Working Group may wish to consider whether this sentence should be somewhat altered and moved to the article 1(g) definition of “right of control”. Should the Working Group decide to move the sentence, the suggested modifications to the chapeau and to subparagraph (d), *supra* note 180, should be readdressed.

<sup>182</sup> The concern was raised in paragraph 102 of A/CN.9/526 that the phrase “give or modify instructions ... that do not constitute a variation of the contract” might be read as contradicting themselves. It was stated in response that a clear distinction should be made in substance between what was referred to as a minor or “normal” modification of instructions given in respect of the goods and a more substantive variation of the contract of carriage. These concerns could be reflected by deleting the words placed in square brackets, since they would seem to be unnecessary in light of the limits within which the right can be exercised are set out in subparagraph 11.3(a) (now article 55(1)).

<sup>183</sup> See *supra*, note 180.

<sup>184</sup> The question was raised in paragraph 105 of A/CN.9/526 why the consent of the consignee was required to designate a controlling party other than the shipper, when the consignee was not a party to the contract of carriage. Further, it was observed that if the contract provided for the shipper to be the controlling party, subparagraph (ii) (now paragraph 1(b)) conferred to him the power to unilaterally transfer his right of control to another person. These concerns were addressed by placing the words that follow the words “unless the shipper” in square brackets for possible deletion and inserting instead, in square brackets, the text “designates the consignee or another person as the controlling party”.

<sup>185</sup> The concern mentioned in paragraph 107 of A/CN.9/526 that in certain countries, the transfer of the right of control could not be completed by a mere notice given by the transferee to the carrier could be met by deleting the words “or the transferee” in subparagraph 11.2(a)(ii) (now paragraph 1(b)). This phrase placed in square brackets.

~~(c) (iii)~~ When the controlling party exercises the right of control in accordance with article ~~53 41.1~~, it shall produce proper identification.

~~[(d) (iv)]~~ The right of control [terminates] [is transferred to the consignee] when the goods have arrived at destination and the consignee has requested delivery of the goods.<sup>186</sup>

2. ~~(b)~~ When a negotiable transport document is issued, the following rules apply:

~~(a) (i)~~ The holder<sup>187</sup> or, in the event that more than one original of the negotiable transport document is issued, the holder of all originals is the sole controlling party.

~~(b) (ii)~~ The holder is entitled to transfer the right of control by passing the negotiable transport document to another person in accordance with article ~~59 42.1~~, upon which transfer the transferor loses its right of control. If more than one original of that document was issued, all originals must be passed in order to effect a transfer of the right of control.

~~(c) (iii)~~ In order to exercise the right of control, the holder shall, if the carrier so requires, produce the negotiable transport document to the carrier. If more than one original of the document was issued, all originals [except those that the carrier already holds on behalf of the person seeking to exercise a right of control] shall be produced, failing which the right of control cannot be exercised<sup>188</sup>.

~~(d) (iv)~~ Any instructions as referred to in article ~~53(b), (c) and (d) 41.1(ii), (iii), and (iv)~~ given by the holder upon becoming effective in accordance with article ~~55 41.3~~ shall be stated on the negotiable transport document.

<sup>186</sup> As mentioned in paragraph 106 of A/CN.9/526 and in paragraph 188 of A/CN.9/WG.III/WP.21, the controlling party remained in control of the goods until their final delivery. However, nothing is said in paragraph 11.2 (now article 54) regarding the time until which the right of control can be exercised in case non-negotiable transport document or electronic record is issued. It is thought that something could be said to take care of the observation that has been made, and subparagraph 11.2(a)(iv) (now paragraph 1(d)) has been added. Note, however, that paragraph 106 of A/CN.9/526 also notes the concern that the common shipper's instruction to the carrier not to deliver the goods before it had received the confirmation from the shipper that payment of the goods had been effected could be frustrated. Further, since article 53 states that the right of control is the right to give the carrier instructions during the period of responsibility as set out under article 7, it may be unnecessary to state when the right of control ends.

<sup>187</sup> As noted in paragraph 109 of A/CN.9/526, the concern raised in respect of the reference to the "holder" does not seem to be justified in consideration of the definition of "holder" in paragraph 1.12 (now article 1(f)).

<sup>188</sup> As noted in paragraph 110 of A/CN.9/526, the Working Group was in agreement that subparagraph 11.2(b)(iii) (now paragraph 2(c)) did not sufficiently address the consequences of the situation where the holder failed to produce all copies of the negotiable document to the carrier, and that in such cases, the carrier should be free to refuse to follow the instructions given by the controlling party. The Working Group was generally of the opinion that, should not all copies of the bill of lading be produced by the controlling party, the right of control could not be exercised, and that an exception should be made to the rule under which the controlling party should produce all the copies of the bill of lading to address the situation where one copy of the bill of lading was already in the hands of the carrier. In order to meet these concerns, it is suggested that the phrases noted should be added to subparagraph 11.2(b)(iii) (now paragraph 2(c)).

3. ~~(e)~~ When a negotiable electronic record is issued:

~~(a) (i)~~ The holder is the sole controlling party and is entitled to transfer the right of control to another person by passing the negotiable electronic record in accordance with the rules of procedure referred to in article ~~6 2.4~~, upon which transfer the transferor loses its right of control.

~~(b) (ii)~~ In order to exercise the right of control, the holder shall, if the carrier so requires, demonstrate, in accordance with the rules of procedure referred to in article ~~6 2.4~~, that it is the holder.

~~(c) (iii)~~ Any instructions as referred to in article ~~53(b), (c) and (d) 11.1, (ii), (iii), and (iv)~~ given by the holder upon becoming effective in accordance with article ~~55 11.3~~ shall be stated in the electronic record.<sup>189</sup>

4. ~~(d)~~ Notwithstanding ~~the provisions of article 62 12.4~~, a person, not being the shipper or the person referred to in article ~~31 7.7~~, that transferred the right of control without having exercised that right, shall upon such transfer be discharged from the liabilities imposed on the controlling party by the contract of carriage or by this instrument.<sup>190</sup>

#### Article 55.

~~1. 11.3~~ ~~(a)~~ Variant A of paragraph 1<sup>191</sup>

Subject to ~~the provisions of paragraphs 2 and 3 (b) and (e)~~ of this article, if any instruction mentioned in article ~~53(a), (b) or (c) 11.1(i), (ii), or (iii)~~

~~(a) (i)~~ can reasonably be executed according to its terms at the moment that the instruction reaches the person to perform it;

~~(b) (ii)~~ will not interfere with the normal operations of the carrier or a performing party; and

~~(c) (iii)~~ would not cause any additional expense, loss, or damage to the carrier, the performing party, or any person interested in other goods carried on the same voyage,

then the carrier shall execute the instruction. If it is reasonably expected that one or more of the conditions mentioned in sub-paragraphs ~~(a), (b), (c) (i), (ii), and (iii)~~ of this paragraph is not satisfied, then the carrier is under no obligation to execute the instruction.<sup>192</sup>

<sup>189</sup> As noted in paragraph 112 of A/CN.9/526, the Working Group deferred consideration of subparagraph 11.2(c) (now paragraph 3) until it had come to a more precise understanding of the manner in which the issues of electronic commerce would be addressed.

<sup>190</sup> As noted in paragraph 113 of A/CN.9/526, the Working Group found the substance of subparagraph 11.2(d) (now paragraph 4) to be generally acceptable.

<sup>191</sup> Variant A of paragraph 1 is based on the original text of the draft instrument.

<sup>192</sup> As noted in paragraph 117 of A/CN.9/526, the Working Group generally agreed that subparagraph 11.3(a) (now paragraph 1) should be recast to reflect the views and suggestions in paragraphs 114 to 116. It was agreed that the new structure of the paragraph should address, first, the circumstances under which the carrier should follow the instructions received from the controlling party, then, the consequences of execution or non-execution of such instructions. The Secretariat was requested to prepare a revised draft of the provision, with possible variants, for continuation of the discussion at a future session.

Variant B of paragraph 1

Subject to paragraphs 2 and 3 of this article, the carrier shall be bound to execute the instructions mentioned in article 53(a), (b), and (c) ~~11.1(i), (ii) and (iii)~~ if:

~~(a) (i)~~ the person giving such instructions is entitled to exercise the right of control;

~~(b) (ii)~~ the instructions can reasonably be executed according to their terms at the moment that they reach the carrier;

~~(c) (iii)~~ the instructions will not interfere with the normal operations of the carrier or a performing carrier.<sup>193</sup>

2. ~~(b)~~ In any event, the controlling party shall ~~indemnify~~ reimburse<sup>194</sup> the carrier, performing parties, and any persons interested in other goods carried on the same voyage ~~against~~ for any additional expense that they may incur and indemnify them against any, loss, or damage that they may ~~occur~~ suffer as a result of executing any instruction under this article.<sup>195</sup>

3. ~~(e)~~ [If ~~a~~ the carrier

~~(a) (i)~~ reasonably expects that the execution of an instruction under this article will cause additional expense, loss, or damage; and

~~(b) (ii)~~ is nevertheless willing to execute the instruction,

then the carrier is entitled to obtain security from the controlling party] If requested by the carrier, the controlling party shall provide security<sup>196</sup> for the amount of the reasonably expected additional expense, loss, or damage.

<sup>193</sup> As noted in paragraph 114 of A/CN.9/526, to avoid a contradiction between subparagraphs 11.3(a)(iii) (now paragraph 1(c)) and subparagraph 11.1(ii) (now article 53(b)) with respect to the right of control and the possible generation of “additional expenses”, it was suggested that either the carrier should be under no obligation to execute the instruction received under subparagraph 11.1(ii) (now article 53(b)) or that subparagraph 11.3(a)(iii) (now paragraph 1(c)) should limit the obligation of the carrier to execute to cases where the instruction would not cause “significant” additional expenses. Further, as noted in paragraph 115 of A/CN.9/526, broad support was expressed in the Working Group for the deletion of subparagraph 11.3(a)(iii) (now paragraph 1(c)). In view of these suggestions, subparagraph 11.3(a) (now paragraph 1) could be reworded as indicated, and the right of the carrier under subparagraph 11.3(c) (now paragraph 3) could be made more stringent, as indicated *infra* note 196. In addition, subparagraph 11.3(a)(iii) (now paragraph 1(c)) has been deleted.

<sup>194</sup> As noted in paragraph 56 of A/CN.9/510 and in paragraph 118 of A/CN.9/526, the notion of “indemnity” inappropriately suggested that the controlling party might be exposed to liability, and that notion should be replaced by that of “remuneration”, which was more in line with the rightful exercise of its right of control by the controlling party.

<sup>195</sup> The changes to subparagraph 11.3(b) (now paragraph 2) have been made in view of the suggestion in paragraph 117 of A/CN.9/526 that the new structure of the paragraph should address, first, the circumstances under which the carrier should follow the instructions received from the controlling party, then, the consequences of execution or non-execution of such instructions.

<sup>196</sup> Although subparagraph 11.3(c) (now paragraph 3) was found “generally acceptable”, as noted in paragraph 119 of A/CN.9/526, the changes indicated have been made in connection with the comments on subparagraph 11.3(a) (now article 51(1)). See note 193 *supra*.

4. (d) The carrier shall be liable for loss of or damage to the goods resulting from its failure to comply with the instructions of the controlling party in breach of its obligation under paragraph 1 of this article.<sup>197</sup>

Article 56.

~~11.4~~ Goods that are delivered pursuant to an instruction in accordance with article ~~53(b)~~ ~~11.1(ii)~~ are deemed to be delivered at the place of destination and the provisions relating to such delivery, as laid down in ~~chapter article~~ 10, are applicable to such goods.<sup>198</sup>

Article 57.

~~11.5~~ If during the period that the carrier or a performing party holds the goods in its custody, the carrier or a performing party reasonably requires information, instructions, or documents in addition to those referred to in article ~~27(a)~~ ~~7.3(a)~~, ~~it shall seek such information, instructions, or documents from the controlling party~~ the controlling party, on request of the carrier or such performing party, shall provide such information.<sup>199</sup> If the carrier, after reasonable effort, is unable to identify and find the controlling party, or the controlling party is unable to provide adequate information, instructions, or documents to the carrier, the obligation to do so shall be on the shipper or the person referred to in article ~~31~~ ~~7.7~~.

Article 58.

~~11.6~~ The provisions of ~~Articles 53(b) and (c)~~ ~~11.1 (ii) and (iii)~~, and ~~55~~ ~~11.3~~ may be varied by agreement between the parties. The parties may also restrict or exclude the transferability of the right of control referred to in article ~~54(1)(b)~~ ~~11.2 (a)(ii)~~. If

<sup>197</sup> As noted in paragraph 116 of A/CN.9/526 a question was raised regarding the nature of the obligation incurred by the carrier under paragraph 11.3 (now article 55), and whether the carrier should be under an obligation to perform or under a less stringent obligation to undertake its best efforts to execute the instructions received from the controlling party. The view was expressed that the former, more stringent obligation, should be preferred. However, the carrier should not bear the consequences of failure to perform if it could demonstrate that it had undertaken reasonable efforts to perform or that performance would have been unreasonable under the circumstances. As to the consequences of the failure to perform, it was suggested that the draft instrument should be more specific, for example, by establishing the type of liability incurred by the carrier and the consequences of non-performance on the subsequent execution of the contract. In furtherance of these views, a new subparagraph 11.3(d) (now paragraph 4) has been added. As regards the consequences of the non-execution of the instructions, obviously where such execution should have taken place, it is assumed that the implied intention was to provide that the carrier would be liable in damages. If the Working Group decides to include a provision to that effect, it may also wish to consider whether there should be a limitation on such liability.

<sup>198</sup> As noted in paragraph 120 of A/CN.9/526, the Working Group found the substance of paragraph 11.4 (now article 56) to be generally acceptable.

<sup>199</sup> As noted in paragraph 121 of A/CN.9/526, the suggestion that paragraph 11.5 (now article 57) should allow the carrier the choice to seek instructions from "the shipper or the controlling party" was not supported. As noted in paragraph 122 of A/CN.9/526, the suggestion to add reference to the performing party in addition to the carrier, to the performing party was generally supported. In view also of the recommendation mentioned in paragraph 123 of A/CN.9/526, changes have been made in an attempt to clarify the formulation of the subparagraph 11.5 (now article 57).

a negotiable transport document or ~~an~~ a negotiable electronic record is issued, any agreement referred to in this paragraph must be stated or incorporated<sup>200</sup> in the contract particulars.

## CHAPTER 12. TRANSFER OF RIGHTS

### Article 59.

~~1. 12.1.1~~ If a negotiable transport document is issued, the holder is entitled to transfer the rights incorporated in such document by passing such document to another person,

(a) ~~(i)~~ if an order document, duly endorsed either to such other person or in blank, or,

(b) ~~(ii)~~ if a bearer document or a blank endorsed document, without endorsement, or,

(c) ~~(iii)~~ if a document made out to the order of a named party and the transfer is between the first holder and such named party, without endorsement.<sup>201</sup>

~~2. 12.1.2~~ If a negotiable electronic record is issued, its holder is entitled to transfer the rights incorporated in such electronic record, whether it be made out to order or to the order of a named party, by passing the electronic record in accordance with the rules of procedure referred to in article ~~6 2.4~~.<sup>202</sup>

### Article 60.

~~1. 12.2.1~~ Without prejudice to ~~the provisions of article 57 11.5~~, any holder that is not the shipper and that does not exercise any right under the contract of carriage, does not assume any liability under the contract of carriage solely by reason of becoming a holder.<sup>203</sup>

~~2. 12.2.2~~ Any holder that is not the shipper and that exercises any right under the contract of carriage, assumes [any liabilities imposed on it under the contract of carriage to the extent that such liabilities are incorporated in or ascertainable from the negotiable transport document or the negotiable electronic record] [the liabilities

<sup>200</sup> As noted in paragraph 126 of A/CN.9/526, there was broad support in the Working Group that the revised draft of paragraph 11.6 (now article 58) should avoid suggesting any restriction to the freedom of parties to derogate from article 11 (now chapter 11). Further, it appears to be implied that the last sentence of subparagraph 11.6 (now article 58) should apply only if a negotiable document or electronic record is issued. This has consequently been mentioned in the revised text, together with the suggested reference to agreements incorporated by reference.

<sup>201</sup> As noted in paragraph 133 of A/CN.9/526, there was strong support in the Working Group to maintain the text of subparagraph 12.1.1 (now article 59(1)) as drafted in order to promote harmonization and to accommodate negotiable electronic records. The concern raised in paragraph 132 of A/CN.9/526 regarding nominative negotiable documents under certain national laws was noted.

<sup>202</sup> As noted in paragraph 134 of A/CN.9/526, the Working Group took note that subparagraph 12.1.2 (now paragraph 2) would be discussed at a later date in conjunction with the other provisions in the draft instrument regarding electronic records.

<sup>203</sup> As noted in paragraph 136 of A/CN.9/526, there was some support in the Working Group for the view that the concept in subparagraph 12.2.1 (now paragraph 1) was superfluous. However, it does not appear that there was enough support in the Working Group for this conclusion.

imposed on the controlling party under chapter 11 and the liabilities imposed on the shipper for the payment of freight, dead freight, demurrage and damages for detention to the extent that such liabilities are incorporated in the negotiable transport document or the negotiable electronic record]<sup>204</sup>.

3. ~~12.2.3~~ Any holder that is not the shipper and that

(a) ~~(i)~~ under article ~~4 2.2~~ agrees with the carrier to replace a negotiable transport document by a negotiable electronic record or to replace a negotiable electronic record by a negotiable transport document, or

(b) ~~(ii)~~ under article ~~59 12.1~~ transfers its rights,

does not exercise any right under the contract of carriage for the purpose of ~~the articles paragraphs 1 12.2.1 and 2 12.2.2.~~<sup>205</sup>

#### Article 61.

~~[12.3~~The transfer of rights under a contract of carriage pursuant to which no negotiable transport document or no negotiable electronic record is issued shall be effected in accordance with the provisions of the ~~national law applicable to the contract of carriage relating to transfer of rights~~ applicable law. Such transfer of rights may be effected by means of electronic communication. A transfer of the right of control cannot be completed without a notification of such transfer to the carrier ~~[by the transferor or the transferee].~~<sup>206</sup>

#### Article 62.

~~[12.4~~If the transfer of rights under a contract of carriage pursuant to which no negotiable transport document or no negotiable electronic record has been issued includes the transfer of liabilities that are connected to or flow from the right that is transferred, the transferor ~~and the transferee are jointly and severally liable in~~

<sup>204</sup> As noted in paragraph 140 of A/CN.9/526, the Working Group requested the Secretariat to prepare a revised draft of subparagraph 12.2.2 (now paragraph 2) with due consideration being given to the views expressed. However, the views expressed in the preceding paragraphs 137 to 139 are not consistent. Those that favoured a revision of the text requested that the subparagraph stipulate which liabilities the holder that exercised any right under the contract of carriage would assume pursuant to that contract. Despite there being opposition to such an itemization, an attempt has been made to revise the text. It should be noted that there is a relevant type of liability that ought perhaps to be considered: the liability in respect of loss, damage or injury caused by the goods (but excluding in any event that for breach of the shipper's obligations under paragraph 7.1 (now article 25)).

<sup>205</sup> As noted in paragraph 141 of A/CN.9/526, the Working Group found the substance of subparagraph 12.2.3 (now paragraph 3) to be generally acceptable.

<sup>206</sup> As noted in paragraph 142 of A/CN.9/526, concern was raised with respect to a conflict that could arise between paragraph 12.3 (now article 61) and national law in countries where notice of transfer of rights must be given by the transferor, and may not be given by the transferor or the transferee. Alternative suggestions were made in paragraph 142 of A/CN.9/526, but the first suggestion, consisting in the addition at the end of the final sentence of a reference to the national law applicable to the contract of carriage, might conflict with the subsequent suggestion in paragraph 143 of A/CN.9/526 to refer generally in the first sentence to the "applicable law" rather than to "the provisions of the national law applicable" in order to avoid potentially complex conflict of law issues. Thus, the alternative suggestion, to delete the final words "by the transferor or the transferee" was preferable, and these words have been placed in square brackets. Further,



~~respect of such liabilities shall not be discharged from liability unless with the consent of the carrier.]~~<sup>207</sup>

### CHAPTER 13. RIGHTS OF SUIT

#### Article 63.

#### Variant A<sup>208</sup>

~~13.1~~ Without prejudice to articles ~~64~~ ~~13.2~~ and ~~65~~ ~~13.3~~, rights under the contract of carriage may be asserted against the carrier or a performing party only by:

(a) ~~(i)~~ the shipper,

(b) ~~(ii)~~ the consignee,

(c) ~~(iii)~~ any third party to which the shipper or the consignee has ~~assigned~~ transferred<sup>209</sup> its rights,

depending on which of the above parties suffered the loss or damage in consequence of a breach of the contract of carriage,

(d) ~~(iv)~~ any third party that has acquired rights under the contract of carriage by subrogation under the applicable national law, such as an insurer.

In case of any passing of rights of suit through assignment or subrogation as referred to above, the carrier and the performing party are entitled to all defences

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the suggestion to insert a reference to the applicable law in the first sentence has been adopted, and the entire article has been placed in square brackets, as suggested.

<sup>207</sup> As noted in paragraph 148 of A/CN.9/526, in light of the discussion with respect to draft article 12 (now chapter 12) and to paragraph 12.4 (now article 62) in particular, the Working Group requested the Secretariat to prepare and place in square brackets a revised draft of paragraph 12.4 (now article 62), with due consideration being given to the views expressed. The relevant suggestion made in the paragraphs 147 of A/CN.9/526 is that the liability of the transferor and the transferee should not necessarily be joint and several. It has been suggested, as an alternative, that the transferor shall not be discharged from liability without the consent of the carrier. In addition, the Working Group may wish to consider the following alternative text to replace articles 61 and 62:

“Article 61 bis.

1. If no negotiable transport document and no negotiable electronic record is issued, the transfer of rights under a contract of carriage is subject to the law governing the contract for the transfer of such rights or, if the rights are transferred otherwise than by contract, to the law governing such transfer. [However, the transferability of the rights purported to be transferred is governed by the law applicable to the contract of carriage.]

2. Regardless of the law applicable pursuant to paragraph 1, the transfer may be made by electronic means, and it must, in order to be valid, be notified to the carrier [either by the transferor or by the transferee].

3. If the transfer includes liabilities that are connected to or flow from the right that is transferred, the transferor and the transferee are jointly and severally liable in respect of such liabilities.”

<sup>208</sup> Variant A of article 63 is based on the original text of the draft instrument.

<sup>209</sup> This change is suggested to make the language in this article consistent with those under this chapter.

and limitations of liability that are available to it against such third party under the contract of carriage and under this instrument.<sup>210</sup>

Variant B

Any right under or in connection with a contract of carriage may be asserted by any person having a legitimate interest in the performance of any obligation arising under or in connection with such contract, where that person suffered loss or damage.<sup>211</sup>

Article 64.

~~13.2~~—In the event that a negotiable transport document or negotiable electronic record is issued, the holder is entitled to assert rights under the contract of carriage against the carrier or a performing party, ~~without having to prove that it itself has~~ irrespective of it itself having suffered loss or damage. ~~If such holder did not suffer the loss or damage itself, it is be deemed to act on behalf of the party that suffered such loss or damage.~~<sup>212</sup>

Article 65.

~~13.3~~—In the event that a negotiable transport document or negotiable electronic record is issued and the claimant is ~~one of the persons referred to in article 13.1~~ without being not the holder, such claimant must, in addition to its burden of proof that it suffered loss or damage in consequence of a breach of the contract of carriage, prove that the holder did not suffer ~~such~~ the loss or damage in respect of which the claim is made.<sup>213</sup>

<sup>210</sup> As noted in paragraph 157 of A/CN.9/526, while strong support was expressed for the deletion of paragraph 13.1 (now article 63), the Working Group decided to defer any decision regarding paragraph 13.1 (now article 63) until it had completed its review of the draft articles and further discussed the scope of application of the draft instrument.

<sup>211</sup> As noted in paragraph 157 of A/CN.9/526, the Secretariat was requested to prepare alternative wording in the form of a general statement recognizing the right of any person with a legitimate interest in the contract of transport to exercise a right of suit where that person had suffered loss or damage. The Working Group may wish to consider whether this language adequately deals with the situation of the freight forwarder.

<sup>212</sup> Although no request appears to have been made to the Secretariat in respect of paragraph 13.2 (now article 64) (see articles 160 and 161 of A/CN.9/526), from a drafting perspective, the language could be improved as suggested. Moreover, it is questionable whether the last sentence is necessary. In fact, if the right of the holder is recognized irrespective of such holder having suffered loss or damage, the relation between the holder and the person who has suffered the loss or damage remains outside the scope of the draft instrument.

<sup>213</sup> As noted from the discussion of this provision in paragraph 162 of A/CN.9/526, the Secretariat has not been requested to make a new draft. However, certain drafting changes are suggested as indicated.

CHAPTER 14. TIME FOR SUITArticle 66.~~14.1~~ Variant A<sup>214</sup>

The carrier ~~is shall be~~ discharged from all liability in respect of the goods if judicial or arbitral proceedings have not been instituted within a period of [one] year. The shipper ~~is shall be~~ discharged from all liability under chapter 7 of this instrument if judicial or arbitral proceedings have not been instituted within a period of [one] year.<sup>215</sup>

Variant B

All [rights] [actions] relating to the carriage of goods under this instrument shall be extinguished [time-barred] if judicial or arbitral proceedings have not been commenced within the period of [one] year.

Article 67.

~~14.2~~—The period mentioned in article ~~66~~ ~~14.1~~ commences on the day on which the carrier has completed delivery to the consignee of the goods concerned pursuant to article ~~7(3) or 7(4)~~ ~~4.1.3 or 4.1.4~~ or, in cases where no goods have been delivered, on the [last] day on which the goods should have been delivered. The day on which the period commences is not included in the period.<sup>216</sup>

<sup>214</sup> Variant A of article 66 is based on the original text of the draft instrument.

<sup>215</sup> As noted in paragraph 169 of A/CN.9/526, the Working Group requested the Secretariat to place “one” in square brackets, and to prepare a revised draft of paragraph 14.1 (now article 66), with due consideration being given to the views expressed.

Concern was raised in paragraph 166 of A/CN.9/526 regarding why the time for suit for shippers referred only to shipper liability pursuant to article 7 (now chapter 7) of the draft instrument, and why it did not also refer to shipper liability pursuant to other articles, such as article 9 (now chapter 9). A further suggestion was made that all persons subject to liability under the contract of carriage should be included in paragraph 14.1 (now article 66). It could be suggested that while not all liability arising out of the contract of carriage is regulated in the draft instrument, e.g. the liability of the carrier for its failure to ship the goods, it might be appropriate that article 14 (now chapter 14) would apply to all liabilities regulated in the draft instrument.

The suggestion in paragraph 166 of A/CN.9/526 to simply state that any suit relating to matters dealt with in the draft instrument is barred (or any right extinguished) might be a good solution.

Concern was also raised in paragraph 167 of A/CN.9/526 whether the lapse of time extinguishes the right or bars the action. The lapse of time extinguishes the right under the Hague-Visby Rules (article 3(6)), COTIF-CIM (article 47), Warsaw (article 29) and probably CMR (article 32). It extinguishes the action under the Hamburg Rules (article 20), the 1980 Multimodal Convention (article 25), CMNI (article 24) and Montreal (article 35). It might be advisable if at present both alternatives should be considered. Therefore, an alternative text has been suggested in Variant B.

<sup>216</sup> As noted in paragraph 174 of A/CN.9/526, the Working Group requested the Secretariat to retain the text of paragraph 14.2 (now article 67), with consideration being given to possible alternatives to reflect the views expressed.

Concern was raised in paragraph 170 of A/CN.9/526 that since the date of delivery “in the contract of carriage” might be much earlier than the date of actual delivery, the date of actual delivery was a preferred point of reference. However, concern was raised that delivery could be unilaterally delayed by the consignee. The text refers to the day “on which the carrier has completed delivery”, which is the day of actual delivery. Considering the language in subparagraph 4.1.1 (now article 7(1)) the words “to the consignee” might be added for consistency.

Concern was also raised in paragraph 171 of A/CN.9/526 with respect to the “last day” on which the goods should have been delivered as the commencement of the time period for suit in the cases

Article 68.

~~14.3~~—The person against whom a claim is made at any time during the running of the period may extend that period by a declaration to the claimant. This period may be further extended by another declaration or declarations.<sup>217</sup>

Article 69.

~~14.4~~— An action for indemnity by a person held liable under this instrument may be instituted even after the expiration of the period mentioned in article ~~66~~ ~~14.4~~ if the indemnity action is instituted within the later of

(a) the time allowed by the law of the State where proceedings are instituted;  
or

(b) Variant A<sup>218</sup>

90 days commencing from the day when the person instituting the action for indemnity has either

(i) settled the claim; or

(ii) been served with process in the action against itself.

Variant B

90 days commencing from the day when either

(i) the person instituting the action for indemnity has settled the claim;  
or

(ii) a final judgment not subject to further appeal has been issued against the person instituting the action for indemnity.<sup>219</sup>

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where no goods had been delivered. It may be difficult to find an alternative to this phrase, and in any event, since when goods have not been delivered the “last day” is even more difficult to establish. It is suggested that these words be deleted.

The concern was also raised in paragraph 172 of A/CN.9/526 that the plaintiff could wait until the end of the time period for suit to commence his claim, and possibly bar any subsequent counterclaim against him as being beyond the time for suit. It would be possible to prevent this either through inclusion of counterclaims under subparagraph 14.4(b)(ii) (now article 69(b)(ii)) as noted in paragraph 172, or in a separate paragraph of the draft instrument. See *infra* the alternative text for paragraph 14.5 (now article 71).

It was also suggested in paragraph 173 of A/CN.9/526 that different commencement dates should be fixed in respect of claims against the carrier and against the shipper. This would seem to be an unnecessary complication.

<sup>217</sup> As noted in paragraph 175 of A/CN.9/526, the Working Group found the substance of paragraph 14.3 (now article 68) to be generally acceptable.

<sup>218</sup> Variant A of article 69 is based on the original text of the draft instrument.

<sup>219</sup> As noted in paragraph 178 of A/CN.9/526, the Working Group requested the Secretariat to prepare a revised draft of paragraph 14.4 (now article 69), with due consideration being given to the views expressed.

It was noted in paragraph 176 of A/CN.9/526 that in certain civil law countries, it was not possible to commence an indemnity action until after the final judgment in the case had been rendered, and it was suggested that the 90-day period be adjusted to commence from the date the legal judgment is effective. Alternative language was offered that the 90-day period should run from the day the judgment against the recourse claimant became final and unreviewable. These suggestions are reflected in Variant B.

Article 70.

14.4 bis A counterclaim by a person held liable under this instrument may be instituted even after the expiration of the limitation period mentioned in article 66 ~~14.1~~ if it is instituted within 90 days commencing from the day when the person making the counterclaim has been served with process in the action against itself.<sup>220</sup>

Article 71.

[~~14.5~~If the registered owner of a vessel defeats the presumption that it is the carrier under article ~~36(3)~~ ~~8.4.2~~, an action against the bareboat charterer may be instituted even after the expiration of the period mentioned in article ~~66~~ ~~14.1~~ if the action is instituted within the later of

- (a) the time allowed by the law of the State where proceedings are instituted;
- or
- (b) 90 days commencing from the day when the registered owner [both
    - (i) proves that the ship was under a bareboat charter at the time of the carriage; and]
    - [(ii)] adequately identifies the bareboat charterer.]<sup>221</sup>

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<sup>220</sup> It was reiterated in paragraph 177 of A/CN.9/526 that provision should be made in respect of counterclaims, either pursuant to subparagraph 14.4(b)(ii) (now article 69(b)(ii)) or in a separate subparagraph, but they should be treated in similar fashion to subparagraph 14.4(b)(ii) (now article 69(b)(ii)). Paragraph 14.4 bis (now article 70) sets out this provision as a separate article.

<sup>221</sup> As noted in paragraph 182 of A/CN.9/526, the Working Group requested the Secretariat to prepare a revised draft of paragraph 14.5 (now article 71), with due consideration being given to the views expressed. Note was also taken that the Working Group had requested the Secretariat to retain subparagraph 8.4.2 (now article 36(3)) in square brackets, and that it therefore requested the Secretariat to retain paragraph 14.5 (now article 71) in square brackets, bearing in mind that the fate of the latter article was linked to that of the former.

The link between paragraph 14.5 (now article 71) and subparagraph 8.4.2 (now article 36(3)) was noted in paragraph 179 of A/CN.9/526, and the square brackets around paragraph 14.5 (now article 71) have been retained.

Concern was raised in paragraph 180 of A/CN.9/526 that the 90 day period would not be of assistance if the cargo claimant experienced difficulties in identifying the carrier. It is thought that this problem is solved by the present subparagraph 14.5(b)(ii) (now paragraph (b)(ii)).

It was also suggested that subparagraphs (i) and (ii) of subparagraph 14.5(b) (now paragraph (b)) be combined into one, since subparagraph (ii) could be considered a sufficiently rigorous condition to subsume subparagraph (i). A revised text is proposed.

CHAPTER 15. JURISDICTION<sup>222</sup>Variant AArticle 72.

In judicial proceedings relating to carriage of goods under this instrument the plaintiff, at his option, may institute an action in a court which, according to the law of the State where the court is situated, is competent and within the jurisdiction of which is situated one of the following places:

(a) The principal place of business or, in the absence thereof, the habitual residence of the defendant; or

[(b) The place where the contract was made provided that the defendant has there a place of business, branch or agency through which the contract was made; or]<sup>223</sup>

(c) The place of receipt or the place of delivery; or

(d) Any additional place designated for that purpose in the transport document or electronic record.

Article 73.

Notwithstanding article 72, an action may be instituted in the courts of any port or place in a State Party at which the carrying vessel [or any of the carrying vessels] or any other vessel owned by the carrier may have been arrested in accordance with applicable rules of the law of that State and of international law.

Article 74.

No judicial proceedings relating to carriage of goods under this instrument may be instituted in a place not specified in article 72 or 73. This article does not constitute an obstacle to the jurisdiction of the States Parties for provisional or protective measures.

Article 75.

1. Where an action has been instituted in a court competent under article 72 or 73 or where judgement has been delivered by such a court, no new action may be started between the same parties on the same grounds unless the judgement of the court before which the first action was instituted is not enforceable in the country in which the new proceedings are instituted.

<sup>222</sup> As noted in paragraph 159 of A/CN.9/526, the Working Group requested the Secretariat to prepare draft provisions on issues of jurisdiction and arbitration, with possible variants reflecting the various views and suggestions expressed in the course of the discussion .

Two alternative versions of the provisions on jurisdiction and arbitration have been prepared, both based on articles 21 and 22 of the Hamburg Rules with the necessary language changes. Variant A of chapters 15 and 16 reproduces fully the provisions of the Hamburg Rules, while Variant B of chapters 15 and 16 omits the paragraphs that the CMI International Sub-Committee on Uniformity of the Law of Carriage by Sea suggested should be deleted (see CMI Yearbook 1999, p. 113 and, for greater detail, CMI Yearbook 1997, p. 350-356).

<sup>223</sup> See *supra* note 30.

2. For the purpose of this chapter the institution of measures with a view to obtaining enforcement of a judgement is not to be considered as the starting of a new action;

3. For the purpose of this chapter, the removal of an action to a different court within the same country, or to a court in another country, in accordance with article 73, is not to be considered as the starting of a new action.

#### Article 75 bis.

Notwithstanding the preceding articles of this chapter, an agreement made by the parties, after a claim under the contract of carriage has arisen, which designates the place where the claimant may institute an action, is effective.

#### Variant B

#### Article 72.

In judicial proceedings relating to carriage of goods under this instrument the plaintiff, at his option, may institute an action in a court which, according to the law of the State where the court is situated, is competent and within the jurisdiction of which is situated one of the following places:

(a) The principal place of business or, in the absence thereof, the habitual residence of the defendant; or

[(b) The place where the contract was made provided that the defendant has there a place of business, branch or agency through which the contract was made; or]<sup>224</sup>

(c) The place of receipt or the place of delivery; or

(d) Any additional place designated for that purpose in the transport document or electronic record.

#### Article 73.

Notwithstanding article 72, an action may be instituted in the courts of any port or place in a State Party at which the carrying vessel [or any of the carrying vessels] or any other vessel owned by the carrier may have been arrested in accordance with applicable rules of the law of that State and of international law.

#### Article 74.

No judicial proceedings relating to carriage of goods under this instrument may be instituted in a place not specified in article 72 or 73 of this article. This paragraph does not constitute an obstacle to the jurisdiction of the States Parties for provisional or protective measures.

#### Article 75.

Notwithstanding the preceding articles of this chapter, an agreement made by the parties, after a claim under the contract of carriage has arisen, which designates the place where the claimant may institute an action, is effective.

<sup>224</sup> See *supra* note 30.

CHAPTER 16. ARBITRATION<sup>225</sup>Variant AArticle 76.

Subject to this chapter, the parties may provide by agreement evidenced in writing that any dispute that may arise relating to the contract of carriage to which this Instrument applies shall be referred to arbitration.

Article 77.

If a negotiable transport document or a negotiable electronic record has been issued the arbitration clause or agreement must be contained in the documents or record or expressly incorporated therein by reference. Where a charter-party contains a provision that disputes arising thereunder shall be referred to arbitration and a negotiable transport document or a negotiable electronic record issued pursuant to the charterparty does not contain a special annotation providing that such provision shall be binding upon the holder, the carrier may not invoke such provision as against a holder having acquired the negotiable transport document or the negotiable electronic record in good faith.

Article 78.

The arbitration proceedings shall, at the option of the claimant, be instituted at one of the following places:

(a) A place in a State within whose territory is situated:

(i) The principal place of business of the defendant or, in the absence thereof, the habitual residence of the defendant; or

[(ii) The place where the contract of carriage was made, provided that the defendant has there a place of business, branch or agency through which the contract was made; or]<sup>226</sup>

(iii) The place where the carrier or a performing party has received the goods for carriage or the place of delivery; or

(b) Any other place designated for that purpose in the arbitration clause or agreement.

Article 79.

The arbitrator or arbitration tribunal shall apply the rules of this instrument.

Article 80.

Article 77 and 78 shall be deemed to be part of every arbitration clause or agreement, and any term of such clause or agreement which is inconsistent therewith shall be null and void.

<sup>225</sup> See *supra* note 222. Variant A of chapter 16 reproduces fully the provisions of the Hamburg Rules, while Variant B of chapters 16 omits the paragraphs that the CMI International Sub-Committee on Uniformity of the Law of Carriage by Sea suggested should be deleted.



Article 80 bis.

Nothing in this chapter shall affect the validity of an agreement on arbitration made by the parties after the claim relating to the contract of carriage has arisen.

Variant BArticle 76.

Subject to this chapter, the parties may provide by agreement evidenced in writing that any dispute that may arise relating to the contract of carriage to which this instrument applies shall be referred to arbitration.

Article 77.

If a negotiable transport document or a negotiable electronic record has been issued the arbitration clause or agreement must be contained in the documents or record or expressly incorporated therein by reference. Where a charter-party contains a provision that disputes arising thereunder shall be referred to arbitration and a negotiable transport document or a negotiable electronic record issued pursuant to the charterparty does not contain a special annotation providing that such provision shall be binding upon the holder, the carrier may not invoke such provision as against a holder having acquired the negotiable transport document or the negotiable electronic record in good faith.<sup>227</sup>

Article 78.<sup>228</sup>Article 79.

The arbitrator or arbitration tribunal shall apply the rules of this instrument.

Article 80.

Nothing in this chapter shall affect the validity of an agreement on arbitration made by the parties after the claim relating to the contract of carriage has arisen.

CHAPTER 17. 15.—GENERAL AVERAGEArticle 81.

~~15.1~~—Nothing in this instrument prevents the application of provisions in the contract of carriage or national law regarding the adjustment of general average.<sup>229</sup>

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<sup>226</sup> See *supra* note 30.

<sup>227</sup> The amended text of article 73 of the provision on arbitration in Variant B is not a reproduction of Article 22.2 of the Hamburg Rules, since it was thought that Article 22.2 of the Hamburg Rules was too specific.

<sup>228</sup> In order that Variant B accurately reflects the deliberations of the CMI International Sub-Committee on Uniformity of the Law of Carriage by Sea, this paragraph has been omitted. No decision was reached by the CMI regarding a suitable replacement paragraph. (Again, see CMI Yearbook 1999, p. 113 and, for greater detail, CMI Yearbook 1997, p. 350-356.)

<sup>229</sup> As noted in paragraph 186 of A/CN.9/526, there was broad support in the Working Group for the continued incorporation of the York-Antwerp Rules on general average into the contract of carriage. The substance of paragraph 15.1 (now article 81) was found to be generally acceptable.

Article 82.

~~1.15.2~~ [With the exception of the provision on time for suit,] the provisions of this instrument relating to the liability of the carrier for loss of or damage to the goods shall also determine whether the consignee may refuse contribution in general average and the liability of the carrier to indemnify the consignee in respect of any such contribution made or any salvage paid.

2. All [actions for] [rights to] contribution in general average shall be [time-barred] [extinguished] if judicial or arbitral proceedings have not been instituted within a period of [one year] from the date of the issuance of the general average statement.<sup>230</sup>

CHAPTER 18. 16. OTHER CONVENTIONSArticle 83.

~~16.1 bis~~ Subject to article 86 ~~16.2~~, nothing contained in this instrument shall prevent a contracting state from applying any other international instrument which is already in force at the date of this instrument and which applies mandatorily to contracts of carriage of goods primarily by a mode of transport other than carriage by sea.<sup>231</sup>

Article 84.

~~16.2 bis~~ As between parties to this instrument its provisions prevail over those of an earlier treaty to which they may be parties [that are incompatible with those of this instrument].<sup>232</sup>

<sup>230</sup> As noted in paragraph 188 of A/CN.9/526, it was suggested that the fact that the time for suit provisions of the draft instrument do not apply to general average should be expressed more clearly. Since paragraph 15.2 (now paragraph 1) states that the provisions on liability of the carrier determine whether the consignee may refuse contribution in general average and the liability of the carrier, the reference to the time for suit provision is confusing. It is suggested that it should be deleted. This is particularly the case if a specific time for suit provision is added.

As further suggested in paragraph 188 of A/CN.9/526, a separate provision could be established in respect of time for suit for general average awards, such as, for example, that the time for suit for general average began to run from the issuance of the general average statement. A text has been prepared and added to the end of paragraph 15.2 (now paragraph 2). Such a provision should probably cover both claims for contribution and claims for indemnities.

In paragraph 189 of A/CN.9/526, the question was raised whether paragraph 15.2 (now paragraph 1) should also include liability for loss due to delay and demurrage. No decision appears to have been made by the Working Group in this regard.

<sup>231</sup> As previously mentioned in connection with subparagraph 4.2.1 (now article 8) and discussions relating to the relationship of the draft instrument with other transport conventions and with domestic legislation (see note 42 *supra*), the Secretariat was also instructed in paragraphs 247 and 250 of A/CN.9/526 to prepare a conflict of convention provision for possible insertion in article 16 (now chapter 18). It is suggested that this should not adversely affect the suggestion that appears in the following note, but should instead supplement that suggestion. The language of this new paragraph 16.1 bis (now article 83) is taken from article 25(5) of the Hamburg Rules.

<sup>232</sup> The suggestion in paragraph 196 of A/CN.9/526 that it would be helpful if paragraph 16.1 (now article 85) were amended to add language stating that the draft instrument would prevail over other transport conventions except in relation to States that are not member of the instrument is in line with the provisions of article 30(4) of the Vienna Convention. It is suggested, however,

Article 85.

~~16.1~~—This instrument does not modify the rights or obligations of the carrier, or the performing party provided for in international conventions or national law governing the limitation of liability relating to the operation of [~~seagoing~~]<sup>233</sup> ships.

Article 86.

~~16.2~~—No liability arises under ~~the provisions of~~ this instrument for any loss of or damage to or delay in delivery of luggage for which the carrier is responsible under any convention or national law relating to the carriage of passengers and their luggage [by sea]<sup>234</sup>.

Article 87.

~~16.3~~—No liability arises under ~~the provisions of~~ this instrument for damage caused by a nuclear incident if the operator of a nuclear installation is liable for such damage:

(a) under ~~either~~ the Paris Convention ~~of 29 July 1960~~, on Third Party Liability in the Field of Nuclear Energy ~~of 29 July 1960~~ as amended by the ~~a~~Additional Protocol of 28 January 1964, ~~or~~ the Vienna Convention ~~of 21 May 1963~~, on Civil Liability for Nuclear Damage ~~of 21 May 1963~~, as amended by the Joint Protocol Relating to the Application of the Vienna Convention and the Paris Convention of 21 September 1988, and as amended by the Protocol to Amend the 1963 Vienna Convention on Civil Liability for Nuclear Damage of 12 September 1997, or the Convention on Supplementary Compensation for Nuclear Damage of 12 September 1997, or

(b) by virtue of national law governing the liability for such damage, provided that such law is in all respects as favourable to persons who may suffer damage as either the Paris or Vienna Conventions or the Convention on Supplementary Compensation for Nuclear Damage.<sup>235</sup>

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that this new provision should be added in a separate paragraph, rather than to the present paragraph 16.1 (now article 85), that deals with a different and more specific problem and settles such problem in the opposite direction. This new provision appears as paragraph 16.2 bis (now article 84).

<sup>233</sup> The word “seagoing” in paragraph 16.1 (now article 85) has been deleted, as suggested in paragraph 197 of A/CN.9/526.

<sup>234</sup> As instructed in paragraph 199 of A/CN.9/526, square brackets have been placed around the words “by sea”.

<sup>235</sup> As noted in paragraph 202 of A/CN.9/526, the Working Group requested the Secretariat to update the list of conventions and instruments in paragraph 16.3 (now article 87), and to prepare a revised draft of paragraph 16.3 (now article 87), with due consideration being given to the views expressed.

In paragraph 200 of A/CN.9/526, it is pointed out that the list of conventions in paragraph 16.3 (now article 83) is not complete and reference is made to the 1998 Protocol to amend the 1963 Vienna Convention.

It is noted in paragraph 201 of A/CN.9/526 that the suggestion was made that other conventions touching on liability could be added to those listed in paragraph 16.3 (now article 87), such as those with respect to pollution and accidents. However, some objections were raised in this respect, and, as a consequence, it is suggested that the review mentioned in the subsequent paragraph 202 of A/CN.9/526 should relate only to conventions in the area of nuclear damage.

CHAPTER 19.17. [LIMITS OF CONTRACTUAL FREEDOM] [CONTRACTUAL STIPULATIONS]<sup>236</sup>

Article 88.

~~1. 17.1~~ (a) Unless otherwise specified in this instrument, any contractual stipulation that derogates from ~~the provisions of this instrument~~ are is null and void, if and to the extent it is intended or has as its effect, directly or indirectly, to exclude, [or] limit [, or increase] the liability for breach of any obligation of the carrier, a performing party, the shipper, the controlling party, or the consignee under ~~the provisions of this instrument.~~<sup>237</sup>

2. (b) ~~[Notwithstanding paragraph 1 (a), the carrier or a performing party may increase its responsibilities and its obligations under this instrument.]~~<sup>238</sup>

3. (c) Any stipulation assigning a benefit of insurance of the goods in favour of the carrier is null and void.<sup>239</sup>

Article 89.

~~17.2~~ Notwithstanding ~~the provisions of chapters 4.5 and 5.6~~ of this instrument, both the carrier and any performing party may by the terms of the contract of carriage: ~~exclude or limit their liability for loss of or damage to the goods if~~

(a) exclude or limit their liability if the goods are live animals except where it is proved that the loss, damage or delay resulted from an action or omission of the carrier or its servants or agents done recklessly and with knowledge that such loss, damage or delay would probably occur, or

(b) exclude or limit their liability for loss or damage to the goods if the character or condition of the goods or the circumstances and terms and conditions under which the carriage is to be performed are such as reasonably to justify a special agreement, provided that ordinary commercial shipments made in the

<sup>236</sup> As noted in paragraph 204 of A/CN.9/526, it was suggested that the title of this draft article should be revised to reflect more accurately the contents of the provision, which did not deal with "limits of contractual freedom" in general, but dealt with clauses limiting or increasing the level of liability incurred by the various parties involved in the contract of carriage. A possible alternative is the title of article 23 of the Hamburg Rules, "Contractual stipulations". Otherwise the title might indicate the basic mandatory nature of the provisions of the Instrument.

<sup>237</sup> As noted in paragraph 213 of A/CN.9/526, the Working Group decided to maintain the text of subparagraph 17.1 (a) (now paragraph 1) in the draft instrument, including the words "or increase" in square brackets, for continuation of the discussion at a future session, possibly on the basis of one or more new proposals. It was indicated, as noted in paragraph 212 of A/CN.9/526 that a proposal for a draft provision excluding "competitively negotiated contracts between sophisticated parties" would be made available to the Secretariat before the next session of the Working Group, and that the concerns noted in paragraphs 205 to 211 of A/CN.9/526 would be borne in mind when drafting that proposal.

<sup>238</sup> As noted in paragraph 214 of A/CN.9/526, the Working Group found the substance of subparagraph 17.1 (b) (now paragraph 2) to be generally acceptable. It was decided that the square brackets around that provision should be removed.

<sup>239</sup> As noted in paragraph 215 of A/CN.9/526, the Working Group found the substance of subparagraph 17.1 (c) (now paragraph 3) to be generally acceptable.

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ordinary course of trade are not concerned and no negotiable transport document or negotiable electronic record is or is to be issued for the carriage of the goods.<sup>240</sup>

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<sup>240</sup> As noted in paragraph 217 of A/CN.9/526, the Working Group decided that the substance of subparagraph 17.2 (a) (now paragraph (a)) should be maintained in the draft instrument for continuation of the discussion at a future session. The Secretariat was requested to prepare alternative wording to limit the ability of the carrier and the performing party carrying live animals to exonerate themselves from liability in case of serious fault of misconduct. Further, it was noted in paragraph 218 of A/CN.9/526 that the Working Group found the substance of subparagraph 17.2 (b) (now paragraph (b)) to be generally acceptable. The suggested different treatment of subparagraphs 17.2 (a) and (b) (now paragraphs (a) and (b)) requires a change in the chapeau. As regards live animals, it is suggested that language similar to that used in respect of the loss of the right to limit liability could be used, however, extending the reckless behaviour to servants or agents.

**D. Working paper on the preparation of a draft instrument  
on the carriage of goods [by sea]: proposal by the Netherlands on the  
application door-to-door of the instrument, submitted to the  
Working Group on Transport Law at its twelfth session  
(A/CN.9/WG.III/WP.33) [Original: English]**

In preparation of the twelfth session of Working Group III (Transport Law), the Government of the Netherlands submitted the text of a proposal concerning the scope and structure of the draft instrument for consideration by the Working Group. The text of that proposal is reproduced as an annex to this note in the form in which it was received by the Secretariat.

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## **Annex**

### **1. Summary of position**

(a) The extension of the scope of applicability of the UNCITRAL draft to carriage preceding and/or subsequent to a sea leg fits in a current practice: the majority of maritime contracts nowadays covers door-to-door carriage. Therefore, the creation of a new maritime convention covering port-to-port carriage only, would not make much sense. It would just add another maritime convention to the existing ones.

(b) The practice of door-to-door carriage can be seen in other modes of transport as well. Also the conventions relating to these other modes, in particular the newest ones, reflect a certain ‘unimodal plus’ approach.

(c) The 'maritime plus' approach, as worked out in the current draft, may create conflict of convention problems, because the scope of application provisions of the existing non-maritime conventions are, in general, not sufficiently clear: do they relate to a certain type of contract or to a certain mode? If they relate to a certain type of contract, for example the contract for road haulage, it may be argued that they do not apply to the non-maritime part of a maritime door-to-door carriage.

If they relate to a certain mode, it may be argued that they do apply to the non-maritime part of a maritime door-to-door carriage.

In particular, this problem exists in respect of CMR.

(d) The solution chosen in the UNCITRAL draft for avoidance of conflict of conventions, namely the inclusion of article 4.2.1 and 4.2.2, is acceptable to the Netherlands. Such limited network solution avoids to the largest possible extent conflicts with other conventions. However, in respect of non-liability matters a residual possibility of conflicts remains.

(e) Alternative solutions for multimodal carriage are (i) a uniform multimodal convention, or (ii) a full network (i.e. including non-liability issues) multimodal convention. In the view of the Netherlands each of these solutions have major disadvantages. In addition, as long as no clarity is created in respect of the scope of application of the existing unimodal conventions, the problem of conflicts of conventions is in both alternatives not taken away.

(f) If it is realised that an alignment of the scope of application provisions of the existing unimodal conventions is required for each of the above long term solutions for multimodal carriage, also another long term solution comes in the picture: to amend any existing unimodal convention by extending its scope to carriage to other modes preceding or subsequent to its own mode, and to add an identical conflict of convention provision in each unimodal convention so amended. See paragraphs 133-137 of WP.29.

(g) Such general 'unimodal plus' approach deserves further attention and study, because it may create a break-through in the current impasse relating to any solution of the problem of multimodal carriage. Such study may produce that a 'unimodal plus' system fits neatly in the current practices of the shippers and carriers. In addition, it may solve in Europe the 'shortsea issue'.

(h) In case such general 'unimodal plus' approach finds sufficient support, the conflict of convention provision that is required for each convention could include the option of the commercial parties to make a choice between conventions in case more than one of them might be applicable to a single multimodal door-to-door carriage.

(i) Because the idea of a 'unimodal plus' system as a general solution for multimodal carriage needs further study, it is, at this stage, no alternative for the articles 4.2.1 and 4.2.2. A general 'unimodal plus' system, in the Netherlands' view, does not preclude any of the proposals mentioned in the paragraphs 138-185 of WP.29 either. Therefore, also if one of these proposals will be adopted, the UNCITRAL draft could, in case it eventually would be desirable to accommodate a general 'unimodal plus' system, be adjusted in a later stage (e.g. by additional protocol) without affecting such adopted proposal.

## 2. General scope of the UNCITRAL draft

1. The UNCITRAL draft applies to “contracts of carriage” (in which the place of receipt and the place of delivery are in different States) cf. art. 3.1. Such “Contracts of carriage” are defined as “ a contract under which a carrier ... undertakes to carry goods wholly or partly by sea” (art.1.5). “Carrier” is defined as a contractual person cf. art. 1.1.
2. From these references it may be concluded that the UNCITRAL draft follows a contractual approach. It applies to a certain type of contract with specific economic and operational characteristics. This type of contract is the contract of maritime carriage, which nowadays in many, if not most, cases is related to door-to-door carriage. It means that the goods are not only carried with seagoing ships, but also with other means of transport when such other means of transport are used for carriage preceding or subsequent to the carriage by the seagoing vessel. Such scope of application may be referred to as ‘maritime plus’.
3. In addition, it must be realised that the UNCITRAL draft not only deals with liability matters. It also deals with rights and obligations of the parties under the above ‘contracts of carriage’, which widens its scope much beyond liability for loss, damage and delay to goods only.

## 3. Scope of other transport conventions<sup>1</sup>

4. In Annex 1 a short comparison is made with other conventions. A summary follows hereunder in paragraphs 5-9.
5. All transport conventions, referred to in Annex 1, apply to a certain type of contract of carriage. Just like the UNCITRAL draft, they follow the principle of the contractual approach. Nevertheless, their scope of application provisions may give rise in practice to interpretation problems. Refer paragraph 10.
6. In each unimodal convention the contract of carriage is defined by reference to one mode of transport, but, except in the maritime and road conventions, they may, to a limited extent, include carriage by another modes of transport as well. The clearest examples are:
  - Montreal Convention covers pick-up and delivery services (which are geographically not expressly limited) as well as certain qualified carriage by road, irrespective whether such road carriage is national or international.
  - COTIF-CIM 1999 covers ‘listed’ maritime and inland navigation services, irrespective whether these are national or international, as well as unlisted national road and inland navigation carriage.
7. Hamburg Rules allows other conventions to apply to maritime carriage when such carriage by sea is not the primary mode of transport. Notably, such conflict of convention provision is not taken over in other later conventions.
8. The road, rail and air transport conventions deal also with other contractual matters than carrier’s liability for loss, damage or delay to the goods.

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<sup>1</sup> References to international instruments in this paper are the same as set out in paragraph 5 of WP.29.



9. It may be concluded from the comparison made in Annex 1, that the main features of the general scope of the UNCITRAL draft, i.e. the ‘contractual approach’, the ‘unimodal plus’ system and the coverage of other contractual issues than solely carrier’s liability matters are, to some extent, already included in the non-maritime transport conventions.

The main difference with the UNCITRAL draft is, that the latter elaborates further on these features.

#### 4. Contractual approach may raise interpretation matters

10. It has to be acknowledged that the scope of application provisions of the *unimodal* transport conventions may be interpreted as if such scope also includes an international carriage, which is performed by the ‘convention mode’ under a contract of *multimodal* carriage. The notable example is an international road haulage, which is performed preceding or subsequent to a carriage by air or by sea. Art. 1.1 of CMR may be interpreted to make CMR applicable to such preceding or subsequent carriage. At the end of paragraphs 62 and 63 of WP.29 a reference is made to “strong” arguments in favour of such interpretation, which is further set out in paragraphs 115 and 116 of WP.29. The result of this interpretation is that more than one transport convention may be applied to a single contract of multimodal carriage.

11. Whether this interpretation is right or wrong, is no question. It exists and its result is that the scope of application of the UNCITRAL draft and that of other unimodal conventions may overlap. As a consequence, the matter of conflicts of conventions may arise. In order to avoid such conflicts (which are caused by the lack of clarity of the scope of application provisions of other transport conventions), the UNCITRAL draft has introduced art. 4.2. This article sets priority for the carrier’s liability provisions of the other transport convention.

12. This art. 4.2, however, is on purpose restricted to matters relating to the carrier’s liability only. It doesn’t deal with possible conflicts between provisions in the various conventions relating to other than liability matters. In respect of these ‘non liability’ matters, it is inconceivable that different parts of a single transport would be governed by conflicting provisions. For example, if a negotiable document is issued for a door-to-door carriage, does that document become non-negotiable as soon as the road haulage part begins? If such would be the case, it would upset buyers and sellers under an international sales contract. Another example: under CMR the instruction right of consignors and consignees is linked to (a certain copy) of document issued, which CMR system quite differs from the corresponding proposals in the UNCITRAL draft.

In respect of these other contractual matters the UNCITRAL draft reflects the law, customs and practices of the maritime contract of carriage. These may, and in many cases are, different from those in other unimodal conventions. In fact, all unimodal transport conventions reflect the specific customs and practices inherent to their modes.

13. Therefore, if art. 4.2 would have been extended and would have provided for a full priority of *all* the provisions of the inland transport convention for the inland part of a maritime carriage, it would have created much ambiguity with regard to rights and obligations of the parties other than a carrier’s liability for loss, damage

or delay to the goods. In respect of the carrier's liability provisions alone, a network system is feasible. But with regard to the provisions dealing with other contractual matters than carrier's liability, a choice must be made: to the multimodal contract as a whole either such provisions of the one convention should apply, or such provisions of the other convention should.

14. Because the UNCITRAL draft deals with the contract of maritime carriage and its 'non carrier's liability' provisions reflect the law, customs and practices of the overseas trade, it has no option but to provide for priority of its 'non carrier's liability' provisions over corresponding provisions of any other transport convention that arguably according to its terms could apply to the activities of the maritime carrier on land.

15. Therefore, the Netherlands, while realising that under the interpretation, referred to in paragraphs 115 and 116 of WP.29, a conflict of conventions cannot be fully ruled out, consider such possible conflicts as unavoidable and, in view of the fact that any transport convention has to reflect the customs and practices of the specific mode of transport in order to acquire a sufficient level of commercial acceptance, as tolerable. However, the ultimate political aim should be to create a lasting solution for the multimodal transport contract without possible conflict of conventions situations.

#### 5. Is there a solution for this multimodal problem?

16. Up till now the focus in respect of a solution for the multimodal problem has been on the network system and/or on the uniform system.

The main advantage of the network system is that by its automatic adaptation to the specifics of the relevant mode of transport it is said not to interfere with any of the existing unimodal regimes. However, disadvantages are that (i) it provides patchwork and, therefore, unpredictability for the shipper, (ii) attribution of liability to a certain mode of transport is not always possible, with the result that also a residual liability system is needed, and (iii) there is a risk of gaps between the different modes of transport.

17. It must be noted that within the scope of the network system not much attention has been paid to the above mentioned 'other contractual matters'. Its focus always has been on the liability of the carrier for damage to the cargo. In the opinion of the Netherlands, it is paramount that (at least) two legal conditions must be fulfilled before a full network system can properly be applied to a contract of multimodal carriage:

(a) an adjustment of the scope of application provisions of each unimodal convention in order to clarify that such convention applies to a certain mode of transport and not to a certain type of contract, and

(b) insertion in each unimodal convention of appropriate conflict of convention provisions (which may be complicated) in order to avoid conflicts between the various 'non carrier's liability' provisions of the unimodal conventions involved.

18. The current alternative to the network system is the uniform system. The Multimodal Convention 1980 provides for such a uniform system. Its main advantages are its ease to be applied and the predictability of its result. Nevertheless,

the Multimodal Convention 1980 did not enter into force, arguably because its provisions too much deviate from the practices of the commercial parties involved.

19. The issue of conflict of conventions is also relevant to the Multimodal Convention 1980. The interpretation of the scope of application provisions of the unimodal transport conventions, referred to in the paragraphs 115 and 116 of WP.29, creates equally conflicts with the contractual approach, as provided for in the Multimodal Convention 1980. If the Multimodal Convention 1980 would properly coexist with the unimodal transport conventions, an adjustment of the scope of application provisions of the unimodal conventions is also required. It has to be made clear that the scope of these conventions is restricted to a contract for a certain unimodal carriage and that they do not apply to 'their' mode when this mode is part of a transport under a contract for multimodal carriage.

20. From paragraphs 17 and 19 the conclusion may be drawn that the multimodal problem cannot be solved without an overall, and preferably co-ordinated, adjustment of the scope of application provisions of all unimodal transport conventions.

21. Once it is realised that a solution to the multimodal problem requires the (co-ordinated) amendments of the unimodal transport conventions, other alternatives than a network system or a uniform liability system may come in the picture as a solution for the multimodal problem.

22. One of such other alternatives is the general 'unimodal plus' approach as referred to in paragraphs 133-137 in WP.29. This approach expands on the tendency of the newest transport conventions to extend its scope to supplementary carriage with other modes. Refer paragraph 6 above. Such extension should not be restricted to national carriage by other modes, or to qualified carriage by one mode only, but should be made in respect of any other type of carriage that is preceding or subsequent to the 'own' mode of the transport convention involved.

For instance, it should be made possible that CMR not only applies to international carriage of goods by road, but also continues to apply in the event that these goods are subsequently carried by rail, also when the rail carriage crosses a frontier. And the same should be made possible for COTIF-CIM 1999: this convention should also extend its scope to supplementary international road carriage. This way, two conventions could be equally applicable to the same transport. Which convention actually should apply in such case, must follow from a conflict of convention provision to be included in both conventions. Such conflict provision should, in principle, be identical for both conventions.

23. This alternative solution for the multimodal problem fits also in the current tendency that almost any unimodal carrier offers carriage to destinations that he does not serve with the means of transport of his own mode. He offers such carriage simply because his customers so demand. And the preference of most of these carriers is to do so on the conditions that they are used to work with and which they and their insurers thoroughly know. Therefore, the most preferred conflict of convention provision might be that in cases that more than one convention possibly could apply, the choice is to be made by the parties to the contract of carriage. If the commercial parties would be allowed to make the choice, it may be expected that, in practice, such choice between possibly applicable conventions hardly ever is made explicitly. For example, if the consignor requests a quotation from a European rail

carrier, he will get a price offered under the conditions to which such rail carrier (and its insurers) are used to: the COTIF-CIM. And if he asks for a price from a European road carrier, he will receive one against the conditions under which such road carrier usually contracts: the CMR. In both cases one single contract and one single set of conditions is involved, which is the ultimate aim of any multimodal system. And forwarders might be able to offer both sets of rules, in theory even at a different price.

24. Such ‘unimodal plus’ system combines the advantages of the network system and the uniform system because it has the benefit of the application of sets of rules which are already widely accepted. And it avoids the disadvantage of the network system: the complications of a patchwork, plus residual liability, plus possible gaps between different modes. It has one disadvantage: the existing unimodal conventions have to be amended, preferably in concert. But this disadvantage it has in common with the uniform and the network system.

25. It is obvious that, if the scope of application provisions of each unimodal convention will be extended according to the suggestion in the paragraphs 22 and 23, each such amended convention must include a conflict of convention provision to the effect that the choice of the parties should be respected. Or, in other words, each unimodal convention should allow that it does not apply to a contract of carriage if the parties opt for another convention that, according to its terms, may be applicable.

26. As an example, a draft for such conflict of convention provision is worked out in paragraph 40 of Annex 2. (In this respect, it is remarkable that art. 25.4 of the Hamburg Rules already takes into account a situation that another convention may be applicable to the sea part of a multimodal transport.)

27. If the market place is, within certain limits, allowed to decide which convention regime should apply to a certain multimodal transport, it might be expected that, eventually,

- for intercontinental air carriage (including preceding and/or subsequent inland carriage) the choice will be made for the Montreal Convention;
- for intercontinental maritime transport (including preceding and/or subsequent inland carriage) the choice will be made for the UNCITRAL draft (once it will have entered into force);
- for transport within Europe (including short sea transport, such as cross-North Sea or cross-Baltic ferry transport, international carriage to islands, etc.) the choice will be made for CMR or COTIF-CIM 1999;
- for other regional transport the choice will be made for possible regional conventions that fit in the specific circumstances of the region concerned.

28. In the view of the Netherlands, the general “unimodal plus” approach, as outlined above, deserves further attention and study as an alternative solution to the multimodal problem.

If the outcome of such studies would be that an “unimodal plus” system acquires sufficient support, art. 4.2 of the UNCITRAL should in the subsequent process be replaced by a conflict of conventions provision, which takes into account that other conventions, at the option of the parties, may be applicable to the sea part of an international carriage.

29. Such possible process of realisation of an ‘unimodal plus’ system necessarily takes time. This may be adverse to the urgency of the UNCITRAL draft. As a result, at this moment, a general ‘unimodal plus’ approach seems no substitute for the articles 4.2.1 and 4.2.2. In the Netherlands’ view, however, a general ‘unimodal plus’ system does not conflict with any of the proposals referred to in the paragraphs 138-185 of WP 29 either. Therefore, the adoption of any of such proposals for the UNCITRAL draft does not preclude that a ‘unimodal plus’ system, once it may have acquired sufficient support as a solution for multimodal carriage generally, may be included in the UNCITRAL draft in a later stage. Such inclusion may take place by, for instance, the introduction of an additional protocol. In the Netherlands’ view, the contents of such additional protocol should not necessarily affect any of the above proposals, if adopted, either.

## Annex 1

### Features of other conventions

#### 30. Warsaw Convention

According to its art.1.1 this convention does not apply to a contract, but to a mode of transport: “all international carriage of ... goods performed by aircraft ...”. But, already in the next section, art. 2.1, international carriage” is defined as “any carriage in which, according to the contract made by the parties, the place of departure and the place of destination ... are situated ... within the territory of two high Contracting Parties ...” And in art. 5.2 it is said that “the absence ... of the air consignment note does not affect the existence or validity of the contract of carriage, which shall ... be none the less governed by the rules of this Convention”.

It results that the Warsaw Convention applies to contracts of air carriage as well. With regard to multimodal aspects, according to art. 31 the provisions of Warsaw Convention apply to the air carriage part of a journey only, but it is expressly allowed that in the document of air carriage conditions are inserted relating to other modes of carriage.

The carrier’s liability period is the period that he has the goods in his charge. This period is, to a limited extent, expressly extended to land transport: art. 18.3 includes a presumption that, in case of carriage outside an airport that is made for the purpose of loading, delivery or transshipment, any damage has been the result of an event that took place during the carriage by air. The Convention does not set geographical limit to such ‘pick-up and delivery services’.

As to other matters than liability issues, the Warsaw Convention deals in art. 12-14 with the consignor’s and consignee’s right to dispose of the goods during the carriage, including the right of delivery of the goods.

#### 31. Montreal Convention

This Convention does not change the Warsaw Convention system substantially. New, however, is the legal fiction that must sanction the existing practice that, at least in Europe, a lot of ‘carriage of goods by air’ (intended by the agreement between the parties to be carriage by air) is actually performed by road. Art. 18.4 provides that

such carriage, made without the consent of the consignor, is deemed to be within the period of carriage by air.

Further, Montreal Convention deals somewhat more extensively with other contractual matters than liability matters than Warsaw Convention does.

### 32. Hague-Visby Rules

The scope of this Convention is limited to contracts of carriage by sea. Even, it only applies if a document is issued that constitutes evidence of such contract. Only to a limited extent this Convention deals with other matters than liability issues.

### 33. Hamburg Rules

This Convention applies to contracts of carriage by sea. If a contract involves carriage by sea and by other means of transport, the Convention only applies to the sea part of the carriage.

Other matters than liability issues receive somewhat more attention than in the Hague-Visby Rules.

Attention deserves that the Hamburg Rules include a conflict of conventions provision. Art. 25.4 reads:

“Nothing contained in this Convention prevents a Contracting State from applying any other international convention which is already in force at the date of this Convention and which applies mandatory to contracts of carriage of goods primarily by a mode of transport other than transport by sea. This provision also applies to any subsequent revision or amendment of such international convention.”

This provision means that in case a contract, to which an other transport convention applies, includes a sea part, and such sea part is not the primary mode of that convention, it is allowed that such other transport convention and not the Hamburg Rules applies to such sea part.

### 34. CMR

This convention expressly applies to “every contract for the carriage of goods by road in vehicles ... , when the place of taking over of the goods and the place designated for delivery, as specified in the contract, are situated in two different countries ...”

If the road vehicle does not use its normal infrastructure, i.e. the road, but the vehicle uses for the carriage of the goods, which are loaded in it, another kind of infrastructure, such as a ship to transfer it over sea or a train to transfer it through a tunnel, the CMR remains applicable despite the use of such other kind of infrastructure. However, art. 2 provides for a special rule for the part performed by the vehicle when using such other infrastructure.

Like the Hague-Visby Rules, CMR does not include a reference to any carriage preceding or subsequent to the part carried out by the road vehicle. Instead, in relation to art. 1.4 (containing the excluded kinds of road transport) the Protocol of Signature to the CMR states that “the undersigned undertake to negotiate conventions governing contracts for ... and combined transport.”

Further, it includes several provisions dealing with other contractual matters than liability for loss, damage or delay to the goods.

### 35. COTIF-CIM 1980

According to art.1.1 of this convention the ‘Uniform Rules’ (i.e. the CIM provisions) apply to all consignment of goods for carriage under a through consignment note made out for a route over the territories of at least two states and exclusively over lines or services included in a CIM-list, which is kept by the Intergovernmental organisation for International Carriage by Rail (OTIF). The existence of a consignment note, which includes all kind of contractual details, is a condition for the applicability of the CIM provisions.

Pursuant to art. 2.2 of the underlying COTIF Convention 1980, the CIM provisions “may also be applied to international through traffic using, in addition to services on railway lines, land and sea services and inland waterways. It means that states party to the COTIF 1980 may determine that the CIM provisions should apply to other modes of transport preceding or subsequent to the rail carriage part of the voyage of the goods.

Additionally, from art. 1.2 and art. 48.1 of the CIM provisions it appears that also shipping lines may be included by their governments in the above CIM-list. Thereupon, they have become subject to the convention, but a special regime, which includes the main Hague-Visby Rules exonerations, may be claimed for such shipping lines. Some shipping lines made use of the possibility of inclusion in the CIM-list.

It may be concluded that COTIF-CIM 1980 follows a strictly contractual approach and takes into account the possibility of a rail plus application of the CIM provisions.

Furthermore, COTIF-CIM 1980 includes many provisions other than carrier’s liability for loss, damage or delay to the goods.

### 36. COTIF-CIM 1999

This convention shows some remarkable differences from its predecessor. First, it also applies expressly to contracts of international carriage by rail, but the existence of a consignment note is no longer a condition for the applicability of the convention. The system of a list is maintained, but no longer for railway companies, but only for maritime and international inland waterway services preceding or subsequent to rail carriage, which should become subject to the provisions of the convention. As to such maritime services, again, a special regime may apply, but the number of exonerations for the maritime carrier is substantially reduced.

The convention, however, has a straight multimodal application. Art 1.2 reads: “When international carriage being the subject to a single contract includes carriage by road or inland waterway in internal traffic of a Member State as a supplement to trans-frontier carriage by rail, these Uniform Rules shall apply.”

It means that COTIF-CIM 1990 follows the “rail plus” principle, mandatorily even, but only for national road or inland waterway carriage. Also, COTIF-CIM 1990 still includes many other provisions than those relating to carrier’s liability.

### 37. Budapest Convention (CLNI)

This convention applies to contracts for international carriage of goods by inland waterways. It does not include provisions on carriage with other modes.

By its nature, the carriage must be performed on board of a vessel, but the convention applies equally whether such vessel may be a seagoing vessel or an inland navigation vessel. This lack of distinction in type of vessels makes a kind of conflict of conventions provision necessary: In art. 2.2 it is provided that, if an international carriage of goods, without their transfer from an inland navigation vessel into a seagoing vessel (or vice versa), is both on inland waterways and in “waters to which maritime regulations apply”, the Budapest convention applies, unless (a) “a marine bill of lading has been issued in accordance with the maritime law applicable, or (b) the distance to be travelled in waters to which maritime regulations apply is the greater”.

The convention also includes provisions dealing with other contractual aspects than the liability of the carrier for loss, damage or delay to the goods.

### 38. Multimodal Convention 1980

This convention clearly applies to certain contracts: the carriage must be international and by at least two different modes of transport under a single multimodal contract. Expressly excluded from the definition of multimodal transport are in art 1.1 the pick-up and delivery services performed under an unimodal transport contract.

Further, art. 30.4 provides that carriage to which art. 2 of CMR applies (i.e. the road vehicle using a ship or a train) or to which art 2 of the Berne Convention of 17 February 1970 concerning the carriage of goods by rail applies (i.e. the ‘listed’ road or shipping services complementary to railway services) will not be regarded as multimodal carriage under the Multimodal Convention.

The Multimodal Convention only deals with a limited extent with other provisions than those dealing with the carrier’s liability.

## **Annex 2**

**A possible replacement of art. 1.1 and art. 2 of CMR, just as an example to show how the unimodal ‘plus’ system could work. Any other unimodal convention should be similarly amended with the aim of an alignment of the scope of application provisions and to include an identical conflict of conventions provision.**

### **Definition provision**

39. “Contract of carriage means a contract under which a carrier against payment of freight undertakes to carry goods by [road] [road vehicle] from a place in one state to a place in another state and may include carriage by other [modes] [means] of transport preceding and/or subsequent to the road haulage part of the carriage. If the vehicle containing the goods is carried over part of the journey by sea, rail, inland waterways or air and the goods are not unloaded from the vehicle, such part of the journey shall for the purpose of this Convention be regarded as carriage by [road] [road vehicle].”

*The essence of this provision is that the road haulage part of a carriage (which may include a part during which the road vehicle is carried by another*



*means of transport) is international. The preceding and/or subsequent part of the carriage by other means of transport may be national or international.*

#### **Scope of application provision**

40. “This Convention shall apply to all contracts of carriage if

(a) the place of receipt of the goods as specified in the contract of carriage is located in a Contracting State, or

(b) [the place where the road carriage part of the journey begins or terminates is located in a Contracting State, or]

(c) the place of delivery of the goods as specified in the contract of carriage is located in a Contracting State, [irrespective of the place of residence and the nationality of the parties to the contract of carriage.]”

*This provision follows the usual scope of application provision in transport conventions.*

#### **Conflict of Conventions provision**

41. “If pursuant to the foregoing provisions and to corresponding provisions of another convention governing the relationship between the parties to a transportation contract more than one convention may be applicable to the contract of carriage, the parties must state in the contract of carriage which of the conventions applies to their contract. The parties are not allowed to state that more than one convention, wholly or partly, applies.

In the event that the parties have made the statement in their contract of carriage which convention applies to the contract, any other convention that according to its terms may have applied, shall not apply to the contract of carriage.

In the event that the parties fail to make a statement in their contract of carriage which convention applies to their contract, the convention that according to its terms applies to the contract and covers the geographically longest part of the journey of the goods, shall apply to the contract of carriage. In such event, however, any provision of such convention that limits the liability of the carrier to a certain monetary amount per kilogram or package shall not apply and any contractual provision to provide for such limitation shall be null and void.”

*If the preceding or subsequent carriage is an international carriage, it may be that more than one convention declares itself applicable. Then, it is up to the parties to make a choice. The sanction of the carrier losing its right to limit its liability is regarded as a sufficient incentive to make such choice.*

*Obviously, this opt-in system only works if all possibly applicable unimodal conventions will include this provision.*

**E. Working paper on the preparation of a draft instrument on the carriage of goods [by sea]: proposal by the United States of America, submitted to the Working group on Transport Law at its twelfth session**

**(A/CN.9/WG.III/WP.34) [Original: English]**

In preparation for the twelfth session of Working Group III (Transport Law), during which the Working Group was expected to commence its second reading of a draft instrument on the carriage of goods [by sea] based on a note by the Secretariat (A/CN.9/WG.III/WP.32), the Government of the United States of America, on 11 July 2003, submitted the text of a proposal regarding ten aspects of the draft instrument for consideration by the Working Group. The text of that proposal is reproduced as an annex to this note in the form in which it was received by the Secretariat.

**Annex. Proposal by the United States of America**

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## Introduction

1. The United States welcomes this new initiative by UNCITRAL to promote the cause of harmonization of international transport law. Our gratitude also goes to the *Comité Maritime International* (CMI) for its contribution in this field.
2. At the ninth, tenth, and eleventh sessions of Working Group III, the delegates and observers discussed the individual provisions of the Draft Instrument<sup>1</sup> in isolation. This was a very helpful process, and the United States appreciates all of the constructive views that were expressed during these discussions in an effort to advance the project. We feel that the time has now come, however, to recognize that the controversial issues cannot be resolved on an individual basis. Successfully completing the present project will require commercial compromises in which the various affected industries can each achieve only some of their overall goals.
3. Within the United States, we have consulted with representatives of the major affected industries and they have actively participated in the negotiation process in the effort to achieve a commercial compromise that may be broadly acceptable to all of the affected interests. The current proposal, based on the results of this negotiation process, seeks to address the key contested issues comprehensively. We believe that a convention based on this comprehensive proposal will promote efficiency and uniformity in international trade.
4. This proposal covers ten key subjects that should be addressed in any future convention, but the proposal should be considered as an integrated whole. It represents a careful balancing of interests and equities. This does not mean that the United States is unwilling to discuss individual aspects of this proposal. It simply means that changes to one aspect of the proposal may require reconsideration and revision of other aspects in order to preserve the careful balance of interests that we believe is necessary to achieve much-needed reform. Each of the principal commercial interests involved has already made significant concessions to reach the compromise position expressed here.

### I. Scope of application and performing parties

5. As part of the overall package, the United States supports a door-to-door regime on a uniform liability basis as between the contracting parties, subject to a limited network exception. This means that the contracting carrier's liability to the cargo interests would always be resolved under the Instrument's own substantive liability provisions (including the Instrument's own limitation and exoneration provisions) except when the network principle applies to supersede these provisions. To provide the maximum degree of uniformity possible, we would keep the network exception as narrow as possible. The narrow network exception contained in article 4.2.1 of the Draft Instrument would be acceptable to the United States.
6. In addition to establishing the liability regime between the contracting carrier and the cargo interests, the Instrument should provide the substantive liability rules for "maritime performing parties," meaning those that perform or undertake to perform the contracting carrier's obligations for the port-to-port aspect of the carriage. Maritime performing parties would thus include, for example, ocean

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<sup>1</sup> All references in this proposal to the "Draft Instrument" refer to the Draft Instrument on Transport Law annexed to A/CN.9/WG.III/WP.21.

carriers, feeder carriers, stevedores working in the port area, and marine terminal operators.

7. With regard to other performing parties, the Instrument should not create new causes of action or preempt existing causes of action. For example, the liability of an inland carrier (e.g., a trucker or a railroad) should be based on existing law. In some countries, this may be a regional unimodal convention such as CMR. In others, it may be a mandatory or nonmandatory domestic law governing inland carriage, or the generally applicable tort law. In some countries, cargo interests may not have a cause of action against inland performing parties. Preserving the status quo in this regard would, of course, preserve whatever rights an inland performing party may have under applicable national law to rely on a Himalaya clause to claim the benefit of the contracting carrier's rights under the Instrument. The Instrument should neither increase nor decrease these existing rights.

8. To implement this proposal with respect to performing parties, the United States supports the adoption of the performing party definition suggested in paragraph 16 of the commentary to the Draft Instrument. The definition in article 1.17, which requires "physical" handling of the cargo, is too restrictive. A slightly broadened definition that refers to a party that "performs or undertakes to perform" the contracting carrier's duties would be more appropriate. A party that undertakes to perform a portion of the carriage but then fails to perform at all should not be in a better position than a similarly-situated party that attempts to perform in good faith but does so negligently. Furthermore, to the extent that the motivation to restrict the definition was based on a desire to avoid imposing liability on inland parties that did not physically handle the goods, that concern is addressed by our proposal to exclude all inland performing parties from the Instrument's liability terms.

9. *Recommendations:* To implement this aspect of the proposal, article 1.17 of the Draft Instrument should be amended along the lines proposed in paragraph 16 of the commentary. An additional definition should be added to clarify which performing parties are "maritime" performing parties. Articles 6.3.1 and 6.3.2(b) of the Draft Instrument should be revised so that the Instrument creates a direct cause of action against maritime performing parties only, and article 6.3.3 of the Draft Instrument should be revised so that automatic Himalaya clause protection is extended only to the maritime performing parties that assume liability under the Instrument.

## II. Hague Visby liability limits / procedure for amendment

10. A fundamental element of any new cargo liability Instrument will be the liability limits. At the moment, article 6.7.1 is incomplete; it does not specify the applicable limits, but leaves blank spaces for the numbers that will be provided later. As part of the overall package, the United States supports the completion of article 6.7.1 with the package and weight limits specified in the Hague Visby Rules (i.e., 666.67 SDRs per package or 2 SDRs per kilogram). We believe that the current Hague Visby limits represent a fair balancing of interests. Shippers receive reasonable protections for payment of claims, as the overwhelming majority of claims fall within the Hague-Visby limits.<sup>2</sup> Carriers receive the reasonable level of predictability that they need to make insurance and risk calculations.

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<sup>2</sup> Not only do the overwhelming majority of claims fall within the Hague-Visby limits, but the

11. To ensure that a new Instrument does not become outdated over the years, however, the United States suggests that the Instrument should also include a procedure that could be used to update the liability limits included in the Instrument. As part of the overall package, the United States supports a procedure with the following features: (i) the limits would not be subject to adjustment for a period of seven years from the time the Instrument entered into force or the limits were last adjusted; (ii) before any change is considered, a majority of the parties to the Instrument must forward a proposal for an adjustment for consideration by all of the parties; (iii) a vote of two-thirds of the parties to the Instrument would be required to adjust the limit; (iv) the limit in effect could not be increased or decreased by more than 21 percent in any single adjustment, and in total, the limit could not be increased by more than 100 percent cumulatively above the initial limits; and (v) any adjustment would be effective one year from the date of the vote approving the adjustment.

12. Including an amendment procedure in the new Instrument as described above would allow the Instrument to remain a “living” document and, thus, would avoid the difficulty of having to renegotiate an entirely new treaty simply to update the liability limit in the future. But the proposed procedure would not provide for an automatic adjustment to the limitation. Rather, it would provide for predictability by holding the limitation firm for at least an eight-year period. It would require more than just a few parties to advance a proposal to update the limits and would require a two-thirds vote before an amendment could be adopted. Furthermore, the procedure includes a cap as to the percentage change to the limitation that could be adopted. We believe that this procedure represents a balanced approach for addressing the carrier’s level of liability to be applied in the future.

### III. Exemptions from liability, navigational fault, and burdens of proof

13. As part of the overall package, the United States supports the retention of almost all of the carrier’s exemptions now contained in article 4(2) of the Hague and Hague-Visby Rules in substantially the same form as they now appear in the Hague and Hague-Visby Rules. The only exemption that should be deleted is the navigational fault defense now contained in article 4(2)(a) of the Hague and Hague-Visby Rules (and in article 6.1.2(a) of the Draft Instrument). We would also support the redrafting of the fire defense now contained in article 4(2)(b) of the Hague and Hague-Visby Rules in order to ensure that expanding the scope of application from “tackle-to-tackle” (under the Hague and Hague-Visby Rules) to “door-to-door” (under the new Instrument) does not expand the substance of the fire defense.

14. The defenses included in the Instrument should exonerate a carrier from liability, rather than serve only as a presumption that the carrier was not at fault. There is no real difference in practice between the two approaches. Even under the exoneration system of the Hague and Hague-Visby Rules, a carrier’s right to rely on an exemption is still lost if the cargo interests can prove the carrier’s fault. Thus the exoneration system operates in practice as a presumption system. We nevertheless

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average claim is also well below the Hague-Visby limits. In 2001 (the most recent year for which data is available), the average value of shipments to and from the United States was 0.44 SDRs per kilogram. Furthermore, the so-called “container clause” (which is carried forward as article 6.7.2 of the Draft Instrument) has the practical effect of ensuring that all but the most exceptional “packages” in a containerized shipments are worth less than 666.67 SDRs.

prefer that the list of carrier defenses be retained as exceptions to liability in order to achieve greater predictability and uniformity in the application of the defenses, given the substantial case law that has already developed under existing cargo liability treaties that consider the defenses to exonerate the carrier from liability.

15. Although the United States supports the elimination of the navigational fault defense, we believe that this change creates problems with the current allocation of burdens of proof. Under the allocation of the first alternative in article 6.1.4 of the Draft Instrument, which is consistent with current law in many countries (as explained in paragraph 89 of the commentary), the elimination of the navigational fault defense may well have the unintended effect of depriving the carrier of every statutory defense in any case in which navigational fault could plausibly be argued. The second alternative in article 6.1.4, which is further explained in paragraphs 90-91 of the commentary, corrects this problem. Furthermore, the second alternative offers a more balanced and workable approach toward dealing with situations of partial carrier fault and situations in which the extent of the carrier fault and any applicable exoneration are uncertain.

16. *Recommendation:* To implement this aspect of the proposal, articles 6.1.2 and 6.1.3 of the Draft Instrument should be replaced by a text substantially the same as article 4(2)(c)-(q) of the Hague and Hague-Visby Rules. In addition, article 6.1.4 should be redrafted along the lines of the second alternative. Finally, the fire defense should be included in substantially the following form:

Neither an ocean carrier nor a ship is responsible for loss or damage from fire on a ship unless the fire was caused by the ocean carrier's fault or privity, with respect to a fire on a ship that it furnished. The carrier is not responsible for loss or damage from fire on a ship unless the fire was caused by the carrier's actual fault or privity.

17. This provision introduces the term "ocean carrier," which could be defined as "a performing party that owns, operates, or charters a ship used in the carriage of goods by sea."

#### **IV. Ocean liner service agreements**

18. A key issue in the United States (and we believe in other parts of the world as well) is how the Instrument should treat certain specialized and customized agreements used for ocean liner services that are negotiated between shippers and carriers. As part of the overall package, the United States believes that this kind of agreement, which we refer to as an Ocean Liner Service Agreement ("OLSA"), should be covered by the Instrument, unless the OLSA parties expressly agree to derogate from all or part of the Instrument. A decision to derogate from the Instrument, however, would be binding only on the parties to the OLSA. There are differing views, both within the United States and internationally, on the option to derogate down from the Instrument's liability limits. Nevertheless, the U.S. view is that the parties to an OLSA should be able to depart from any of the Instrument's terms.

##### **A. What is an ocean liner service agreement?**

19. OLSAs have grown in use in many international trades since U.S. regulation of the ocean liner industry was reformed in 1984 and 1998 to allow for

competitively negotiated liner service contracts. As a result, a substantial volume of liner cargo now moves under such agreements in numerous international trade routes.

20. OLSAs are exclusively used for liner services. They are not used for private or industrial carriage with respect to bulk, tanker, neo-bulk or other non-liner cargo services. As such, they are distinguishable from charter parties and volume contracts (mentioned in chapter 3 of the Instrument), which are used for non-liner services.

21. The term “liner service” is well understood in all trades. A liner operation is one used for the carriage of general cargo on an established and regular pattern of trading between a range of specified ports. Unlike private carriage arrangements, a liner vessel sails on a publicly available schedule with regular port calls, whether or not it has cargo to transport. Typically, the liner service is advertised and is available to all customers having cargo that is appropriate to move on the vessels and service offered by the carrier.

22. For purposes of defining contracts qualifying as OLSAs under the Instrument, the following characteristics should be present: (1) they are agreed to by the parties in writing (or comparable electronic means), other than by a bill of lading or transport document issued at the time that the carrier or a performing party receives the goods; (2) they are used for liner services; (3) they involve a carrier service commitment not otherwise required of carriers under the Instrument (e.g. the obligation of the carrier to properly receive, load, stow, carry and deliver the cargo); (4) the shipper agrees to tender a volume of cargo that will be transported in a series of shipments (i.e., the contract covers more than a single shipment); and (5) the shipper and carrier negotiate rates and charges based on the volume and service commitments.

#### **B. Treatment under chapter 17 versus chapter 3 of the Draft Instrument**

23. The United States believes that, as a general matter, all shipments moving under OLSAs should be subject to the Instrument, except to the extent that the parties specifically agree to derogate from all or part of the Instrument’s provisions. This will ensure that the majority of traffic moving under OLSAs are subject to the Instrument, unless the contracting parties expressly agree to derogate. Any agreement to derogate from the provisions of the Instrument shall be binding only on the parties to the OLSA. Thus, when bills of lading or other transport documents are issued for OLSA-based shipments, any party to or holder of the bill of lading or transport document that is not also a party to the OLSA would not be bound by any agreement to derogate from the Instrument.

24. Allowing parties to agree on specialized terms enhances efficiency and has promoted services better tailored to the needs of international businesses. The experience of almost 20 years has shown that neither carrier nor shipper industries are particularly disadvantaged in terms of negotiating power with regard to basic transport terms. Rather, the parties to an OLSA often enter into such contracts with the purpose of designing a customized transportation relationship based on the business needs of the parties.

25. If OLSAs are addressed in chapter 3 and excluded from the Instrument under article 3.3.1, thousands of liner shippers, and a substantial volume of cargo, would be outside of the scope of the Instrument unless the parties entered into a contract

which successfully applied the Instrument as a matter of private contract. The United States strongly opposes this approach. We believe that the Instrument should be the norm that automatically applies door-to-door as between shipper and carrier for shipments moving under an OLSA. When the needs of commerce so require, however, commercial parties should be free to structure their transport arrangements as they see fit, which includes an agreement to derogate from the Instrument.

26. Concern has been expressed that this provision might be unfair to smaller shippers. In practice, this has not been the case with regard to the ability of small shippers to enter into and negotiate the rate and service terms of liner contracts. Moreover, if any shipper is dissatisfied with the result of an OLSA negotiation, it may choose not to enter into the contract and may ship its cargo pursuant to the standard price lists or tariffs typically offered by the liner carriers, or it may ship with a competing carrier. The availability of such standard tariff terms and regularly available competitive alternatives also distinguishes liner shipping from other forms of maritime transport.

27. Unlike treaties dealing with passengers and luggage, which primarily involve carriers and consumers, it is noteworthy that the Instrument will deal almost exclusively with businesses familiar with the requirements of international transactions. A basic level of business knowledge is needed by buyers and sellers of goods to deal with purchase orders and sales agreements, logistics, transfer of title, packing, customs duties, security, letters of credit and other financial documentation, warranties, and insurance. Such parties should also be capable of negotiating special liability terms as part of a particularized contractual transportation service arrangement should they so desire.

28. Finally, because of an issue created by U.S. law, which effectively prevents non-vessel operating common carriers (NVOCCs) from entering into OLSA-type agreements with their customers, we are willing to address certain concerns raised by these interests to avoid unduly disadvantaging NVOCCs. In particular, it would be acceptable to include a provision prohibiting ocean carriers from entering into OLSAs with NVOCCs that include liability limits lower than the standard provided in the Instrument.

### **C. Recommendation**

29. To implement this aspect of the proposal, article 17 should be amended to give the parties to an Ocean Liner Service Agreement the freedom to modify the Instrument's liability terms as explained above. In addition, the term "Ocean Liner Service Agreement" should be defined in the Instrument as follows:

(a) An "Ocean Liner Service Agreement" is a contract in writing (or electronic format), other than a bill of lading or other transport document issued at the time that the carrier or a performing party receives the goods, between one or more shippers and one or more carriers in which the carrier or carriers agree to provide a meaningful service commitment for the transportation by sea (which may also include inland transport and related services) of a minimum volume of cargo in a series of shipments on vessels used in a liner service, and for which the shipper or shippers agree to pay a negotiated rate and tender a minimum volume of cargo.



(b) For purposes of paragraph (a), a “meaningful service commitment” is a service commitment or obligation not otherwise mandatorily required of a carrier under this Instrument.

(c) For purposes of paragraph (a), a “liner service” is an advertised maritime freight transport service using vessels for the carriage of general cargo on an established and regular pattern of trading between a range of specified ports.

(d) An Ocean Liner Service Agreement does not include the charter of a vessel or the charter of vessel space or capacity on a liner vessel.

## **V. Forum selection**

### **A. General Rule**

30. As part of the overall package, the United States believes that the Instrument should limit the permissible forum for litigating or arbitrating claims to certain reasonable places. As a general rule, an approach substantially along the lines adopted in the Hamburg Rules would be acceptable, but two principal revisions would be necessary. First, the Hamburg Rules give the choice among the specified forums to “the plaintiff,” leaving open the possibility that a carrier (the potential defendant in a claim for cargo damage) could bring an action as the plaintiff for a declaration of non-liability, thus preempting the choice that properly belongs to the injured claimant. The Instrument should clarify that the choice is the claimant’s. Second, the list of reasonable forums should be defined as:

- (i) the place where the goods are initially received by the carrier or a performing party from the consignor, or the port where the goods are initially loaded on an ocean vessel;
  - (ii) the place where the goods are delivered by the carrier or a performing party pursuant to article 4.1.3 or 4.1.4, or the port where the goods are finally discharged from an ocean vessel;
  - (iii) the principal place of business or habitual residence of the defendant;
- or
- (iv) the place specified in the contract of carriage or other agreement.

31. This list differs from the Hamburg Rules list in two principal respects. It uses the places of receipt and delivery in addition to the ports of loading and discharge. This change simply recognizes the Instrument’s potential door-to-door application (in contrast with the Hamburg Rules’ port-to-port application). The place of contracting is also omitted from the list. In today’s era of electronic contracting, the place of contracting is often difficult to determine, and is generally irrelevant to the transaction even when it can be determined. Furthermore, it can easily be manipulated if there is any advantage to doing so.

32. Determining the relevant “place” that qualifies as an appropriate forum for cargo claims could be handled in several ways. The Hamburg Rules’ approach (to look to the court that has jurisdiction over the precise physical location mentioned) would be acceptable. This solution, of course, leaves considerable scope to the domestic laws regulating court procedure.

33. The Instrument’s door-to-door application and its treatment of performing parties also require special attention in the drafting of the provision governing

forum selection. In our view, the list of acceptable forums should apply only to actions between the carrier and the cargo interests. The listed forums may not be suitable for actions against a performing party. To the extent that a cargo claimant has a cause of action under the Instrument against a performing party, the plaintiff should be permitted to bring suit in any forum having jurisdiction over the defendant.

#### **B. Exceptions to general rule in OLSA cases**

34. Although an approach substantially along the lines adopted in the Hamburg Rules would be acceptable as a general rule, two exceptions should be allowed in cases involving an OLSA (see part 4, above). First, the parties to an OLSA, as between themselves, should have the ability (for reasons explained above) specifically to agree in writing to derogate from all or part of the Instrument—including the forum provision. Thus the OLSA parties may agree that their own litigation will be in any specified forum (even if this agreement may not bind third parties). This choice should be in lieu of any other choices provided by the Instrument. This freedom may be important in situations in which the parties know that no transport documents will be negotiated to third parties (e.g., a shipment from a company to an overseas branch, or a shipment in which the carrier's contractual counterpart is the consignee).

35. Second, when the parties to an OLSA designate a forum for cargo claims, we believe that the Instrument should provide for the extension of the chosen forum to a subsequent third party (e.g., the consignee or subsequent holder of the bill of lading) under certain conditions, thus binding both the carrier and the third party in actions between them. (The third party would not be bound by any designated forum in an action against a performing party.) In particular, we propose to allow such an extension under the following conditions:

- (i) the parties to the OLSA must expressly agree in the OLSA to extend the forum selected to a subsequent party;
- (ii) the subsequent party to be bound must be provided written or electronic notice of the place where the action can be brought (e.g. in the bill of lading or otherwise);
- (iii) the place or places chosen by the OLSA parties must be
  - (a) the place where the goods are initially received by the carrier or a performing party from the consignor, or the port where the goods are initially loaded on an ocean vessel, or
  - (b) the place where the goods are delivered by the carrier or a performing party pursuant to article 4.1.3 or 4.1.4, or the port where the goods are finally discharged from an ocean vessel, or
  - (c) the principal place of business or habitual residence of the defendant,  
with regard to one or more shipments moving under the relevant OLSA; and
- (iv) the place selected in the OLSA must be located in a country that has ratified the Instrument.

## VI. Qualifying clauses

36. The United States generally supports the risk allocation established by article 8.3 of the Draft Instrument, but in certain situations we feel that the Draft Instrument's treatment of containerized cargo places too great a burden on potential cargo claimants. For the reasons explained in paragraphs 151-152 of the commentary, in such cases cargo claimants legitimately expect greater protection for containerized cargo than the Draft Instrument currently provides. To achieve a fair and sensible means of addressing the issues of what may reasonably be presumed with respect to cargo descriptions provided by shipper, the Instrument should be amended along the lines proposed in paragraphs 153-154 of the commentary.

## VII. Deviation

37. For most of the world, the deviation doctrine does not create any serious problems. Unfortunately, it remains a problem in the United States (and perhaps in some other common law jurisdictions). Although we support the Draft Instrument's treatment of deviation, we nevertheless feel that the text should be revised to clarify that the only deviation for which the carrier can be held liable is an "unreasonable" deviation and that this concept relates only to the routing of an ocean-going vessel (operated by the carrier or a performing party). Similarly, the text should more clearly state that, in the event of an "unreasonable" deviation, the carrier would lose the benefit of its liability limits only pursuant to article 6.8.

38. *Recommendation:* To implement this aspect of the proposal, article 6.5 of the Draft Instrument should be revised as follows:

(a) The carrier is not liable for loss, damage, or delay in delivery caused by any deviation to save or attempt to save life or property at sea, or by any other reasonable deviation.

(b) To the extent that a deviation constitutes a breach of the carrier's obligations under a legal doctrine recognized by national law or in this Instrument, that doctrine applies only when there has been an unreasonable deviation with respect to the routing of an ocean-going vessel.

(c) To the extent that a deviation constitutes a breach of the carrier's obligations, the breach has effect only under the terms of this Instrument. In particular, a deviation does not deprive the carrier of its rights under this Instrument except to the extent provided in article 6.8.

## VIII. Delay

39. The United States supports the Draft Instrument's treatment of liability for delay as expressed in article 6.4.1 without the bracketed language. Because we see delay as a commercial matter that should be negotiated between the parties, we also believe that that—unless otherwise expressly agreed by the parties—compensation for delay should be limited to the amounts due for physical loss or damage, subject to the general liability limits of article 6.7 of the Draft Instrument. In other words, recovery for consequential damages should be permitted only if expressly agreed by the parties. This position would also require the deletion of the bracketed language referring to delay in article 6.8.

40. *Recommendation:* To implement this aspect of the proposal, the bracketed language in article 6.4.1 and the bracketed language referring to delay in article 6.8 should be deleted. Article 6.4.2 should be revised as follows:

If delay in delivery causes loss not resulting from physical loss of or damage to the goods carried, the carrier may be held liable for such loss only if the carrier has expressly agreed to be liable for such loss resulting from delay.

#### **IX. Mixed contracts and shipper's agent arrangements**

41. The United States generally supports the Draft Instrument's treatment of mixed contracts and shipper's agent arrangements as expressed in article 4.3, but we feel that some amendments and clarifications are necessary. Most significantly, we believe that when the carrier is acting not as a "carrier" but as the shipper's or consignee's agent, then article 4.3.2 should apply only as a default rule. The parties should have the freedom expressly to agree on the level of the carrier's duties. We would thus add the phrase "Except as otherwise expressly agreed" at the beginning of article 4.3.2.

#### **X. Misstatement of shipper**

42. Receiving an accurate description of a commodity is vitally important to the safe and successful transport of goods. The nature and value of a commodity will affect the freight rate that a carrier charges, risk management arrangements, physical security, and other measures that might be needed to ensure the successful transport of goods. For this reason, we believe that, without limitation of other provisions in the Instrument related to the failure properly to provide required information, there should be a specific provision to address this concern (as in the third paragraph of article 4(5) of the Hague Rules (article 4(5)(h) of the Hague-Visby Rules)). This provision should declare that the carrier is not liable for loss or damage if the nature or value of the goods was knowingly and materially misstated by shipper.

43. *Recommendation:* To implement this aspect of the proposal, we propose a new provision at the end of article 6.1 as follows:

A carrier is not liable for delay in the delivery of, the loss of, or damage to or in connection with the goods if the nature or value of the goods was knowingly and materially misstated by the shipper in the contract of carriage or a transport document.

**F. Report of the Working Group on Transport Law on the work of its  
thirteenth session (New York, 3-14 May 2004)  
(A/CN.9/552) [Original: English]**

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## Introduction

1. At its thirty-fourth session, in 2001, the Commission established Working Group III (Transport Law) and entrusted it with the task of preparing, in close cooperation with interested international organizations, a legislative instrument on issues relating to the international carriage of goods such as the scope of application, the period of responsibility of the carrier, obligations of the carrier, liability of the carrier, obligations of the shipper and transport documents.<sup>1</sup> The Working Group commenced its deliberations on a draft instrument on the carriage of goods [wholly or partly] [by sea] at its ninth session in 2002. The most recent compilation of historical references regarding the legislative history of the draft instrument can be found in document A/CN.9/WG.III/WP.35.

2. Working Group III (Transport Law), which was composed of all States members of the Commission, held its thirteenth session in New York from 3 to 14 May 2004. The session was attended by representatives of the following States members of the Working Group: Austria, Benin, Brazil, Burkina Faso, Cameroon, Canada, China, Colombia, Fiji, France, Germany, India, Iran (Islamic Republic of) Italy, Japan, Kenya, Lithuania, Mexico, Russian Federation, Singapore, Spain, Sudan, Sweden, Thailand, United Kingdom of Great Britain and Northern Ireland and United States of America.

3. The session was also attended by observers from the following States: Argentina, Australia, Belarus, Brunei Darussalam, Chile, Cuba, Czech Republic, Denmark, Ecuador, Finland, Greece, Kuwait, Mongolia, Netherlands, New Zealand, Nicaragua, Nigeria, Norway, Peru, Philippines, Qatar, Republic of Korea, Senegal, Switzerland, Turkey and Venezuela.

4. The session was also attended by observers from the following international organizations:

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<sup>1</sup> *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 and corrigendum (A/56/17 and Corr.3)*, para. 345.

(a) **Intergovernmental organizations invited by the Commission:** Asian-African Legal Consultative Organization, Intergovernmental Organisation for International Carriage by Rail (OTIF);

(b) **International non-governmental organizations invited by the Commission:** Association of American Railroads (AAR), *Comité Maritime International* (CMI), *Instituto Iberoamericano de Derecho Marítimo*, International Chamber of Commerce (ICC), International Chamber of Shipping (ICS), International Federation of Freight Forwarders Associations (FIATA), International Group of Protection and Indemnity (P&I) Clubs, International Multimodal Transport Association (IMMTA), International Union of Marine Insurance (IUMI), The Baltic and International Maritime Council (BIMCO) and Transportation Intermediaries Association (TIA).

5. The Working Group elected the following officers:

*Chairman:* Mr. Rafael Illescas (Spain)  
*Rapporteur:* Mr. Walter De Sá Leitão (Brazil)

6. The Working Group had before it the following new documents:

(a) Provisional agenda (A/CN.9/WG.III/WP.35);

(b) Provisional redraft of the articles of the draft instrument considered by the Working Group at its twelfth session (A/CN.9/WG.III/WP.36);

(c) Proposal by China on Chapter 19 of the Draft Instrument and the Issue of Freedom of Contract (A/CN.9/WG.III/WP.37).

7. The Working Group adopted the following agenda:

1. Election of officers;
2. Adoption of the agenda;
3. Preparation of a draft instrument on the carriage of goods [wholly or partly] [by sea];
4. Other business;
5. Adoption of the report.

## I. Deliberations and decisions

8. The Working Group continued its review of the draft instrument on the carriage of goods [wholly or partly] [by sea] on the basis of:

- The text contained in the annex to a note by the Secretariat (A/CN.9/WG.III/WP.32);
- A provisional redraft of the articles considered by the Working Group at its twelfth session contained in a note by the Secretariat (A/CN.9/WG.III/WP.36);
- A proposal of the United States of America (A/CN.9/WG.III/WP.34) regarding ten aspects of the draft instrument.

9. The Secretariat was requested to prepare a revised draft of a number of provisions, based on the deliberations and conclusions of the Working Group. Those deliberations and conclusions are reflected in section II below.

## II. Preparation of a draft instrument on the carriage of goods [wholly or partly] [by sea]

### Chapter 5: Liability of the carrier (continued)

#### Draft article 15. Liability of performing parties

10. The Working Group was reminded that it had not had sufficient time during its twelfth session to discuss the last paragraph of draft article 15 of the draft instrument (see A/CN.9/544, para. 181).

##### Paragraph 6

11. The Working Group considered the text of paragraph 6 of draft article 15 as contained in document A/CN.9/WG.III/WP.36 (previously, paragraph 7 of draft article 15 as contained in document A/CN.9/WG.III/WP.32).

##### *Joint and several liability*

12. Questions were raised regarding the relationship between paragraph 6 and paragraph 5 (which expressed the principle that, where more than one maritime performing party was liable, such liability was joint and several). With respect to paragraph 5, the view was expressed that the common law concept of “joint and several liability” might not be interpreted as strictly equivalent to such civil law concepts as “*responsabilité solidaire*” or “*responsabilidad solidaria*” which, in turn, differed from such notions as “*responsabilité conjointe*” or “*responsabilidad mancomunada*”. It was widely felt that further elaboration might be necessary to make it clear in all languages that, where several parties were held liable under paragraph 5, each party was individually responsible for compensating the total loss, subject to any statutory limit applicable and also subject to the recourse action that party might exercise against other liable parties.

##### *Aggregate liability*

13. There was general agreement with the principle expressed in paragraph 6 that, where all of the defendants to a claim were entitled to benefit from the limited liability provisions of the draft instrument, a claimant should be precluded from claiming from the contracting carrier and/or the maritime performing parties an aggregate amount greater than the total limits of liability provided for in the draft instrument.

##### *Set-off—exclusion of non-maritime performing parties*

14. The issue of the set-off of damages amongst defendants to a claim was discussed, and several possible scenarios envisaged. Concerns were raised as to how the principle of aggregate liability would operate in cases of interplay between various liability regimes, which might result in the combination in one claim of defendants who could claim the aggregate limitation on liability and defendants who could not. For example, where both maritime and non-maritime performing parties were liable and the non-maritime parties were subject to higher limits of liability



under applicable law, the effect of paragraph 6 should not be to create a lower limit of liability for such non-maritime parties. However, where compensation would be paid under another liability regime because the claimant had sought compensation in a claim directly against a non-maritime performing party and thereafter claimed against the contracting carrier, the compensation payable by the non-maritime performing party should be set off against the amount claimed from the carrier. Another example was envisaged where the limit of liability was broken in respect of one of the defendants for reasons of wilful misconduct but that limit should still be available to other defendants. With a view to alleviating some of these concerns, the Working Group generally agreed that paragraph 6 should apply to both the contracting carrier and maritime performing parties but that it should clarify that it was not intended to apply to non-maritime performing parties.

15. Regarding the possible formulation of paragraph 6, it was suggested that the words “all such persons” should be replaced by a reference to the contractual carrier and to maritime performing parties. Alternatively, it was suggested that paragraph 6 should read along the following lines: “Without prejudice to article 19, the aggregate liability of all such persons shall, as far as the liability of the contracting carrier and any maritime performing party, not exceed the overall limits of liability under this instrument”. A suggestion was also made that the issue of set-off should be left to applicable domestic law. A further suggestion was that, in preparing a revised draft of paragraph 6, the text of article 10 of the Hamburg Rules might be of assistance.

#### *Placement of paragraphs 5 and 6*

16. It was suggested that paragraphs 5 and 6 should be merged and that, since they should apply to both contracting carriers and maritime performing parties, they should be moved out of article 15, possibly into the provision dealing with limitation of liability.

#### *Conclusions reached by the Working Group on paragraph 6*

17. After discussion, the Working Group decided that:
- Appropriate clarification should be introduced in the draft provision to reflect the consensus reached regarding the meaning of “joint and several liability”;
  - The general principle on aggregate claims expressed in paragraph 6 was appropriate;
  - Paragraphs 5 and 6 should apply to both contracting carriers and maritime performing parties;
  - Paragraphs 5 and 6 should be moved out of draft article 15 into a provision of their own;
  - Further discussion would be needed regarding the feasibility of preparing a uniform rule on the issue of set-off, in the absence of which the issue might need to be left to applicable domestic law;
  - The Secretariat should prepare a revised draft taking into account various possible solutions for the issue of set-off, based on the views and suggestions mentioned above.

## Draft article 16. Delay

18. The Working Group considered the text of draft article 16 as contained in document A/CN.9/WG.III/WP.32.

### *General discussion*

19. Doubts were expressed as to whether the issue of delay in delivery should be addressed at all in the draft instrument. In support of deletion of draft article 16, the view was expressed that the issue was purely commercial in nature and should thus be left for interested parties to deal with in the context of their contractual arrangements. It was explained that, consistent with that view, the issue of delay in delivery was not dealt with in the Hague Rules. Examples were given of situations where a regulation placing too much emphasis on delay in delivery might disregard certain established usages and contractual practices, or even result in compromising the safety of maritime transport. The prevailing view, however, was that the issue of delay in delivery required regulatory treatment and, consistent with other existing liability regimes, including a maritime regime such as the Hamburg Rules, could appropriately be dealt with in the draft instrument.

### **Paragraph 1**

#### *Delay where the parties have expressly agreed upon the time for delivery*

20. There was general support for the notion that the carrier might be liable for breach of its obligation to deliver within a time it had expressly agreed upon. As a matter of drafting, it was suggested that the words “the time expressly agreed upon” used in article 5 (2) of the Hamburg Rules was more accurate than the current formulation of the draft provision.

#### *Delay where the parties have not expressly agreed upon the time for delivery*

21. The discussion focused on whether, in such a case, the carrier should be held liable for delivery after “the time it would be reasonable to expect of a diligent carrier”. The reference to “reasonable time” was objected to on the grounds that it was too subjective, imprecise, open to extensive interpretation by local courts and thus likely increase disharmony in international jurisprudence. In the same line of thought, it was stated that creating an obligation for the carrier to deliver the goods within “reasonable time” would further upset the balance of obligations between carriers and shippers, a balance that was already altered to the detriment of carriers by the deletion of the navigational error exception (see A/CN.9/544, para. 127). In response, it was pointed out that, while paragraph 1 might establish an obligation for the carrier, it should be borne in mind that paragraph 2 provided considerable relief by limiting the carrier’s liability for consequential damages in case of delayed delivery.

22. The prevailing view was that a default rule along the lines of the bracketed text at the end of paragraph 1 was necessary to reflect the general principle that delivery should occur without undue delay. It was pointed out that the reference to “the characteristics of the transport” or “the circumstances of the voyage” provided ample safeguards for established commercial practices that were said to tolerate a degree of imprecision in the application of that principle. It was explained that the

default rule was also necessary to avoid exempting the carrier from liability in situations where a time for delivery was implied, although not expressly agreed upon by the parties. It was also pointed out that, should the default rule contained in paragraph 1 be deleted, the issue would need to be covered by domestic law, a solution that would unnecessarily derogate from the general objective to promote uniform law.

23. With respect to the circumstances listed at the end of paragraph 1, a suggestion was made that “the characteristics of the goods” should be added. Another suggestion was that the end of the paragraph should be simplified to read along the lines of article 5 (2) of the Hamburg Rules, which only referred to “the circumstances of the case”. Yet another suggestion was that, in any event, the reference to “the terms of the contract” should be maintained as essential. With respect to consistency in terminology, a question was raised regarding the expression “place of destination”. It was also suggested that the draft instrument should be checked to avoid unnecessary distinctions between “place” and “location” of delivery, and dispel ambiguity as to whether such location referred to the contractual place of delivery or the actual place of delivery. As a matter of drafting, it was suggested that the words “in the absence of such agreement” should be deleted as superfluous.

*Conclusions reached by the Working Group on paragraph 1*

24. After discussion, the Working Group decided that:
- The draft instrument should reflect the principle that the carrier should be liable for delay in delivery and that such liability should be based on the fault of the carrier;
  - The default rule at the end of the paragraph would be retained without square brackets;
  - The Working Group took note of the suggestions reflected above with respect to the detailed formulation of paragraph 1, and it was understood that the precise wording might need to be further discussed at a future session, based on a revised draft to be prepared by the Secretariat.

**Paragraph 2**

*“loss not resulting from loss of or damage to the goods carried”*

25. Wide support was expressed in favour of retaining in the draft instrument a provision limiting the liability of the carrier for consequential damages (also referred to as “pure economic loss”) resulting from delay in delivery. It was pointed out that such a provision was commonly encountered in international instruments regulating rail and road carriage. As to the formulation of that provision, it was widely felt that the situation where consequential damages were incurred should be described in clearer and less cumbersome wording than current paragraph 2 (“loss not resulting from loss of or damage to the goods carried”).

*“[... times the freight payable on the goods delayed]”*

26. A question was raised as to the reasons for a specific method (i.e. reference to the freight) to be used for determining the liability of the carrier for consequential

damages (and the limitation of such liability) instead of using the general method (i.e., reference to the value of the goods) set forth in draft articles 17 and 18 to calculate compensation in cases of loss or damage to the goods. It was explained that the consequential damages were conceptually distinct from damages to the goods and had no necessary relationship with the value of the goods. As illustrations of that distinction, it was recalled that several existing transport laws and international instruments made reference to the freight for the calculation of the compensation for consequential damages. However, it was also pointed out that the amount of consequential damages might be considerably higher than the value of the goods, while the freight was typically a small fraction of that value. A suggestion that both methods might be combined along the lines of “[... times the freight payable on the goods delayed, or the limit of liability set forth in article 18, whichever is the highest]” received little support.

27. The discussion focused on the multiplier to be applied if the reference to the freight was to be used. Considerable support was expressed in favour of limiting at a low level the compensation owed by the carrier for consequential damages in case of delayed delivery. Accordingly, it was suggested that the limit should be no higher than (one times) the amount of the freight payable on the goods delayed. Suggestions that alternative multipliers such as 2.5 or 4 should also be considered for continuation of the discussion did not receive considerable support. Strong concern was expressed regarding the possibility to break the limit of such compensation under draft article 19 (for continuation of the discussion, see below, paras. 52-62).

#### *Contractual freedom*

28. As a further way of limiting the effect of a provision establishing the liability of the carrier of delayed goods for consequential damages, it was suggested that paragraph 2 should be subject to contractual freedom of the parties. A view held by a considerable number of delegations was that such a reference to contractual freedom would defeat the general principle expressed as a matter of public policy in paragraph 1 (see above, para. 22). However, it was also agreed that the issue might need to be further considered under draft article 19 regarding the loss of the right to limit liability, and also in the context of the general discussion of party autonomy under chapter 19. In that context, it was recalled that a proposal for a revision of paragraph 2 based on freedom of contract had been made in document A/CN.9/WG.III/WP.34, paragraph 40.

#### *Possible conversion to total loss*

29. A proposal was made, based on article 20 (1) of the Convention on the Contract for the International Carriage of Goods by Road (CMR), to the effect that, after expiry of a fixed time period of 90 days from the time when the carrier took over the goods, the fact that goods had not been delivered would be conclusive evidence of the loss of the goods, and the person entitled to make a claim might choose to treat them as lost. While some support was expressed for the proposal, it was pointed out that a provision along those lines might make the draft instrument unnecessarily complex, particularly in view of the fact that additional rules might become necessary to avoid over-compensation if the goods were found after expiry of the 90-day period. Such issues as the passing of ownership of the goods to the

carrier or the option to be provided to the shipper to choose between the goods and the compensation were generally found too complex and detailed to be needed in the draft instrument.

*Placement of paragraph 2*

30. The view was expressed that paragraph 2 might be better located as part of draft article 18. It was generally felt that the issue might need to be reconsidered at a future session.

*Conclusions reached by the Working Group on paragraph 2*

31. After discussion, the Working Group decided that:
- The limitation of the amount payable for consequential damages in case of delayed delivery should be calculated by reference to the freight;
  - The words “[one times] the freight payable on the goods delayed” would be inserted in paragraph 2 for continuation of the discussion at a future session;
  - The words “[Unless otherwise agreed]” would be inserted at the beginning of paragraph 2, together with a footnote indicating that the issue would need to be reassessed in the context of both draft article 19 and chapter 19. A provision along the lines of article 7 (1) of the United Nations Sales Convention should be introduced to promote uniformity in the interpretation of the draft instrument.

## **Draft article 17. Calculation of compensation**

32. The Working Group considered the text of draft article 17 as contained in document A/CN.9/WG.III/WP.32.

### **Paragraph 1**

*General discussion*

33. There was broad support in the Working Group for the contents of paragraph 1. However, some drafting concerns were expressed. There was support for the suggestion that the draft instrument should use consistent terminology such that “the place and time of delivery according to the contract of carriage” in paragraph 1 should be consistent with the text used in draft article 7, and a preference was expressed for the phrasing used in draft article 7. A further suggestion was made that, in light of the discussion in the Working Group regarding draft article 16, it might be advisable to consider a separate article on the calculation of damages due to delay.

*Conclusions reached by the Working Group on paragraph 1*

34. After discussion, the Working Group approved the substance of paragraph 1, subject to redrafting by the Secretariat to improve consistency with draft article 7.

### **Paragraph 2**

*Conclusions reached by the Working Group on paragraph 2*

35. After discussion, the Working Group approved the substance of paragraph 2.

### **Paragraph 3**

#### *General discussion*

36. It was explained that this paragraph was intended to clarify the Hague-Visby Rules, which were unclear as to whether or not claimants were entitled to consequential damages. The paragraph was intended to allow the parties to the contract of carriage to compensate for consequential damages when they made clear their intention to do so pursuant to draft article 88. Some concerns were expressed regarding the treatment of consequential damages and the apparent support of this paragraph for the one-sided mandatory nature of the draft instrument as currently stated in draft article 88, wherein a carrier or a performing party may agree to increase its responsibilities and its obligations.

#### *Conclusions reached by the Working Group on paragraph 3*

37. After discussion, the Working Group approved the substance of paragraph 3.

### **Draft article 18. Limits of liability**

38. The Working Group considered the text of draft article 18 as contained in document A/CN.9/WG.III/WP.32.

### **Paragraph 1**

#### *Level of the limitation on liability*

39. There was agreement in the Working Group that the time was not yet ripe for an exchange of views with respect to the appropriate level of limitation on liability to be inserted into paragraph 1. Views were expressed that an increase from the level in the Hague-Visby Rules would be favoured, and that some States would favour a low level of limitation. There was broad approval of a suggestion that a study should be prepared of the different limitation levels in different States, and with respect to different transport regimes. CMI offered to circulate to its members a questionnaire with respect to the limitation levels applicable to maritime claims and any available information on the value of cargo. In addition, member and observer States of the Working Group agreed to submit to the Secretariat information regarding the limits of liability in their various domestic transport regimes, as well as any available statistics on claims figures, in order to facilitate the proposed study. It was suggested that the Secretariat should request information from the International Maritime Organization (IMO) with respect to inflation rates and liability limits, for example in the context of the Athens Convention.

#### *Amendment procedure*

40. It was proposed that the draft instrument should include a rapid amendment procedure, so that the limitation level, once agreed upon, could be adjusted without reopening the negotiation on the entire instrument. It was noted that a rapid amendment procedure had been proposed in paragraphs 11 and 12 of A/CN.9/WG.III/WP.34. It was suggested that reference could also be had to the

amendment procedure in the Athens Convention. There was broad support for the inclusion of an amendment procedure in the draft instrument.

*Economic loss and “in connection with the goods”*

41. It was stated that the words “in connection with the goods” were drawn from article IV.5.a of the Hague-Visby Rules, where the intent was to cover losses caused by a decrease in the market value of goods during a delay, but not to cover economic loss. It was suggested that if the draft instrument was to cover pure economic loss, a different formulation should be used, such as “the carrier’s liability for loss of or damage to the goods or for delay in delivery”. Some support was expressed for deletion of the words “or in connection with”. In addition, the view was expressed that the exclusion of economic damages from paragraph 1 was achieved through the opening phrase, “[s]ubject to article 16 (2)”.

42. Doubts were expressed as to the above interpretation of the phrase “in connection with the goods”, and whether it would be prudent to delete it. It was suggested that the phrase was intended to include not only damage to the goods, but also damage caused by other circumstances, such as misdelivery or misrepresentation of the goods in the bill of lading. There was strong opposition to the deletion of the phrase. The observation was made that if the phrase was intended to cover misrepresentation and misdelivery, it might be better to place it in a separate article with a different method for calculating compensation. Further, it was observed that if this latter interpretation of the phrase was accurate, it was possible that “in connection with the goods” should also be inserted into draft article 14 (A/CN.9/WG.III/WP.36). As noted in further discussions in the Working Group, the phrase “in connection with the goods” recurred in several other draft articles and it was recommended that its use should be examined by the Secretariat (see below, paras. 44, 58, 89 and 91).

*Possible alternative text*

43. Some support was expressed for replacing paragraph 1 with the alternative text reproduced in footnote 92 of A/CN.9/WG.III/WP.32.

*Conclusions reached by the Working Group on paragraph 1*

44. After discussion, the Working Group decided that:
- The text of paragraph 1 was generally acceptable;
  - The phrase “in connection with” would be placed in square brackets in this and other draft articles for further examination and discussion;
  - The CMI and the member and observer States of the working group would provide data to the secretariat for the preparation of a comparative study on the limitation levels for loss and delay of various transport regimes, including any available claims statistics;
  - The Secretariat should seek to obtain information from the IMO on inflation rates of liability limits;

- The Secretariat would be requested to prepare draft provisions for a rapid amendment procedure for the limitation on liability, using existing models and proposals.

## **Paragraph 2**

### *General discussion*

45. It was recalled that paragraph 2 had been recently discussed at length (A/CN.9/544, paras. 43-50), and that the Working Group had been fairly evenly divided between those who favoured retaining the paragraph and those who favoured its deletion. It had been decided at that time to maintain the provision in square brackets pending the decision of the Working Group on the liability limit set out in paragraph 1.

### *Delay in delivery*

46. It was suggested that delay in delivery should be treated in similar fashion to loss or damage to the goods in paragraph 2. However, it was noted that delays in delivery in intermodal transport would generally be well-documented as the goods changed between modes of transport, such that proving where the delay occurred would be less problematic than proving where concealed damage occurred. It was suggested in response that if the liability limit for damages for delay in draft article 16 remained at a low level, the carrier might not have any incentive to establish where the delay occurred unless the carrier could otherwise be subject to a higher liability limit. However, the point was made that in fact it would be in the carrier's interest to establish where the delay occurred in order to bring a recourse action against the party who caused the delay. Questions were raised regarding whether a rule in this regard would be too favourable to cargo interests, since it was often difficult to decide what was the real cause of the delay, for example, a one-day delay caused by a rail carrier that ultimately resulted in the container missing its ship. Support was expressed both in favour of and against a provision similar to paragraph 2 regarding delays in delivery.

### *Conclusions reached by the Working Group on paragraph 2*

47. After discussion, the Working Group decided that:
- The text of paragraph 2 would be maintained in square brackets;
  - Reference to delay in delivery would be introduced in square brackets in the text of paragraph 2, for continuation of the discussion on that issue.

## **Paragraph 3**

### *General discussion*

48. This paragraph was described as the well-known container rule from the Hague-Visby Rules. There was broad support for the text of this paragraph, however, the question was raised regarding its interaction with the use of a qualifying clause. A suggestion was also made regarding the inclusion of pallets in this paragraph, and the suggestion was made to include pallets by way of the definition of "container" in draft article 1. It was also suggested that the option



should be considered of including a separate limit for containers to replace the package limitation.

*Conclusions reached by the Working Group on paragraph 3*

49. After discussion, the Working Group approved the substance of paragraph 3 and noted that the definition of “container” in draft article 1 might need to be further considered to ensure that it covered pallets.

**Paragraph 4**

*General discussion*

50. General satisfaction was expressed by the Working Group with respect to paragraph 4. It was noted that the paragraph required that the currency be valued at the date of the judgement, so it would not be possible to take advantage of fluctuating currency values in applying this paragraph. A question was raised whether the last sentence of the paragraph could be deleted, since it was duplicated from other conventions and seemed to be mainly of historical interest. A suggestion was made to include in this paragraph a reference to “the date of the arbitral award” or “the date of the final arbitral award”. However, caution was expressed regarding unintended consequences that could result from changes to this well-known text.

*Conclusions reached by the Working Group on paragraph 4*

51. After discussion, the Working Group approved the substance paragraph 4.

**Draft article 19. Loss of the right to limit liability**

52. The Working Group considered the text of draft article 19 as contained in document A/CN.9/WG.III/WP.32.

*General discussion*

53. General agreement was expressed for the policy expressed in draft article 19, under which the limit of liability could be broken in certain exceptional circumstances. How widely such circumstances should be recognized by the draft instrument was considered to be an issue that needed to be balanced against the decision to be made in respect of the amount specified for such limits, particularly under draft articles 18 and 16. It was stated that, should higher limits be specified, it would be justified to make those limits almost unbreakable in practice.

*References to article 16 (2) and to “delay in delivery”*

54. The view was expressed that it would be inappropriate to equate the intent to cause delay in delivery with intent to cause economic loss to the consignee. It was explained that, in certain transport practices, “slow steaming”, “overbooking” or other intentional conduct of the carrier resulting in delay in delivery was customary. Delay might also result from an intentional navigational decision made in the interest of the cargo, for example to avoid a storm. Thus, the mere intent to cause delay (acceptable in certain circumstances) should be distinguished from intent to cause delay with knowledge that economic loss for the consignee would probably result (a situation where the limit of liability should be broken). It was suggested

that, in dealing with the issue of delay, the same distinction might need to be made in draft article 19 and in draft article 16 (1) between delay where a time for delivery had been stipulated in the contract and unreasonable delay in the absence of such stipulation. Alternatively, the following was suggested as a possible additional paragraph dealing with the issue of delay in delivery:

“Neither the carrier nor any of the persons mentioned in article ... shall be entitled to limit their liability as provided in article 16 (2) of this instrument, or a higher limit as provided in the contract of carriage, if the claimant proves that the loss due to delay resulted from a personal act or omission of the person claiming a right to limit done with the intent to cause such loss due to delay or recklessly and with knowledge that such loss due to delay would probably result.”

*Possible reference to article 17*

55. The view was expressed that a reference to article 17 should be added to the list of provisions creating a limit of liability, since article 17 had the same effect as a limit of liability. It was stated in response that the effect of the draft article was not to establish a limit but simply to provide a method for the calculation of compensation.

*Freedom of contract*

56. As regards the possibility that the limit of liability might be made totally unbreakable by contractual arrangement between the parties (possibly through a specific stipulation where the contract of carriage was freely negotiated or, in the case of a contract of adhesion, through a mention in any transport document), the general view was that, in cases of wilful misconduct or reckless behaviour of the carrier, such contractual arrangements should be regarded as contrary to public policy and should not be recognized by the draft instrument.

57. The view was expressed, however, that a reference to the terms of the contract of carriage might be necessary in article 19 to reflect the conditions under which a higher limit of liability stipulated by agreement of the parties (or, depending on decisions to be made in respect of chapter 19, a lower limit) might be broken in exceptional circumstances. In response, it was stated that the case where the parties agreed on a higher limit was already covered by article 18 and the case where a lower limit was stipulated in an Ocean Liner Service Agreement (OLSA), would probably be outside the scope of the draft instrument under chapter 19.

*“damage to or in connection with the goods”*

58. It was widely agreed that the words “in connection with” should be treated as in draft article 18 (see above, paras. 42 and 44).

*“[personal] act or omission”*

59. It was observed that the obligation to prove the personal act or omission of the person claiming a right to limit its liability (for example, the contracting carrier) resulted in the limit of liability being close to unbreakable in practice. Strong support was expressed for extending the scope of draft article 19 to the situation where the intentional or reckless behaviour was that of a servant or agent of the

contracting carrier. Another suggestion was that the words “act or omission of the carrier or any of the persons referred to in draft article 14 bis” should be used. A concern was also expressed as to how the “personal” act or omission of a corporate entity could be demonstrated.

60. Strong support was also expressed for maintaining the reference to the personal act or omission of the person claiming a right to limit its liability, to the exclusion of acts or omissions of the servants or agents of that person. It was stated that a virtually unbreakable limit might deter a lot of litigation. It was also stated that the aim of the draft instrument was not to create a vicarious liability regime that might entail serious difficulties regarding the possible interplay between the draft instrument and the liability regime applicable to a non-maritime subcontractor. It was conceivable that, under the liability regime applicable to the subcontractor, a limit of liability would apply where the limit would be broken under draft article 19 in respect of the contracting carrier. It was suggested that, for the case where such a situation would arise, a rule symmetrical to that contained in draft article 18 (2) would be necessary to ensure that, where a subcontractor whose behaviour caused the damage was protected by an unbreakable limit of liability under the law applicable outside the draft instrument, that limit would extend to the person liable under draft article 19. With respect to the concern expressed in respect of the “personal” act or omission of a corporate entity, it was pointed out that such a “corporate entity” was normally established in the form of a legal person and that the notion of a “personal act or omission” was well established in maritime law and understood to encompass the managers of such a legal person. To alleviate that concern, it was suggested that the words “personal act or omission of” might be replaced by “act or omission within the privity or knowledge of”.

*“recklessly”*

61. The view was expressed that the reference to the “reckless” behaviour of the person claiming a right to limit its liability was uncertain and open to subjective interpretation by national courts. It was suggested that the limit should be breakable only in cases of “intentional or fraudulent” behaviour.

*Conclusions reached by the Working Group on draft article 19*

62. After discussion, the Working Group decided that:
- The reference to “article 15 (3) and (4)” should be updated to read “article 14 bis”;
  - The words “[or as provided in the contract of carriage,]” should be maintained in square brackets pending further discussion on chapter 19;
  - The issue of delay should be further discussed on the basis of a revised draft to be prepared by the Secretariat to reflect the above proposals;
  - The word “personal” should be retained without square brackets;
  - The suggestion to add a reference to article 17 might need to be further discussed in the context of chapter 19.

## Draft article 20. Notice of loss, damage or delay

63. The Working Group considered the text of draft article 20 as contained in document A/CN.9/WG.III/WP.32.

### Paragraph 1

#### *Purpose of paragraph 1*

64. The usefulness of the presumption created in paragraph 1 was widely acknowledged. It was noted that similar provisions had been a feature of maritime law since the presumption first appeared in article III.6 of the Hague Rules, and that its operation since had not created major difficulties. The Working Group heard that its inclusion in the Hague Rules was intended to remedy the situation where failure to provide notice of the loss within the prescribed time limit resulted in a total bar to a claim for that loss. The Hague Rules intended to make it clear that failure to provide such a notice resulted only in the claimant losing the benefit of the presumption that the damage to the cargo had occurred during the period of responsibility of the carrier, and prior to its delivery to the consignee. Further, the Working Group heard the following example regarding the operation of such a provision: the carrier delivered the goods to the consignee's agent, who then took them to the consignee, who failed to inspect them and to provide notice of damage to the carrier within the prescribed time limit. The result would be that the consignee would then lose the benefit of the presumption, and would be required to prove that the damage to the goods occurred before delivery to the consignee's agent. It was observed that the presumption operated to the benefit of both the consignee, who received the benefit of the presumption and who was also protected from being subjected to very short notice periods that could be imposed in a contract of carriage, and the carrier, who received notice of damage in a timely fashion and could thus begin gathering evidence while it was still available.

65. However, the need for paragraph 1 was questioned given the apparent lack of legal consequences for failure to provide the required notice. Since the issuance of the notice, or the failure to provide such a notice, did not affect the respective burdens of proof of the carrier and of the claimant set out in the general liability regime in draft article 14, the question arose of whether paragraph 1 was necessary at all. In light of the Working Group's agreement on the general usefulness of the presumption created by paragraph 1, it was decided to attempt to improve the wording of paragraph 1 to clarify its operation and the consequences entailed by failure to provide the notice. It was also suggested that the attempted redraft should clarify the distinction between providing notice of the existence of damage or loss, which was the intent of paragraph 1, and providing proof of the damage or loss, which would only become necessary later to substantiate the claim.

66. With a view to reflecting some of the above views and suggestions, the following redrafted text of paragraph 1 was proposed to the Working Group:

“1. Notice of loss of or damage to [or in connection with] the goods, indicating the general nature of such loss or damage, shall be given [by or on behalf of the consignee] to the carrier or the performing party who delivered the goods before or at the time of the delivery, or, if the loss or damage is not apparent, within [three working days] [a reasonable time] [\_\_\_working days at

the place of delivery] [\_\_\_consecutive days] after the delivery of the goods. [A court [may] [shall] consider the failure to give such notice in deciding whether the claimant has carried its burden of proof under article 14 (1).] Such a notice is not required in respect of loss or damage that is ascertained in a joint inspection of the goods by the consignee and the carrier or the performing party against whom liability is being asserted.”

67. The redrafted text was welcomed by some as an improvement in that it deleted the presumption in the original version of paragraph 1, and reminded parties that failure to provide notice could make it more difficult to prove their case. It was observed that the bracketed text could also prevent courts from imposing some other sanction for failure to provide notice. There was also continuing support for the original text of paragraph 1, particularly in light of the fact that the text is well known, that it exists in several other transport regimes, and that it is thus familiar to judges in many jurisdictions. One reservation raised with respect to the redrafted text was regarding the clarity of the bracketed sentence, and also the reluctance to appear to be advising courts on how evidence should be assessed. In addition, there was some support for the deletion of paragraph 1 altogether.

*Time for giving notice*

68. The Working Group was generally of the view that if paragraph 1 was to be maintained, “a reasonable time” was an inappropriate time period in which to notify the carrier or the performing party of concealed damage, since it did not provide clear guidance to commercial parties. It was noted that the Hague and Hague-Visby Rules required that this notice be provided within three days. Various time periods were suggested, including 3, 7, 10 and 15 days. The suggestion was also made that, in any event, in the interests of fairness, the time chosen should refer to a certain number of working days rather than consecutive days, particularly if a brief notice period was chosen.

69. A question was raised as to whether the notice period should refer to “the place of delivery” or to “the place of final delivery”. A suggestion was made that the text should read “\_\_\_working days at the place of actual delivery”. The view was expressed that there could be practical difficulties with expiry of the notice period if it was a short period that expired before a road carrier, who picked up the cargo at the dock, delivered it to the consignee, particularly since such a road carrier was unlikely to agree to act as the consignee’s agent, and unlikely to unpack the goods in order to discover concealed damage. However, it was noted that this difficulty would only arise when the contract of carriage was on a port-to-port basis, rather than on a door-to-door basis, since the provision was intended to allocate the risk of any ambiguity about where the damage occurred. It was suggested that in a port-to-port contract of carriage, the consignee should bear the risk once its agent had control of the goods, but it was observed that since most contracts were now door-to-door, this issue would arise much less frequently. There was support for this reasoning, and it was observed that this was the reason why caution had been advised with respect to the inclusion in the draft instrument of mixed contracts of carriage and forwarding in draft article 9 of the draft instrument.

70. A further question was raised regarding the functioning of paragraph 1 in a number of ports where delivery must be made by the carrier to state-controlled parties, such as customs authorities, where neither the carrier nor the consignee

could control the amount of time that might pass before such cargo would actually be delivered to the consignee. The suggestion was made that the notice period in paragraph 1 should thus begin to run only at the time that the consignee physically received the cargo.

71. The prevailing view was that seven days was an appropriate notice period.

*Form of the notice*

72. Concern was expressed that the form in which the notice must be provided was not specified in paragraph 1. While it was noted that parties would, in most cases, send written notice for evidentiary purposes regardless of a requirement to do so, a preference was expressed in the Working Group that it be made explicit that notice should be either in writing, as specified in article 19 (1) of the Hamburg Rules and in article III.6 of the Hague Rules, or that it may be made by electronic means. It was observed that draft article 5, which had not yet been considered by the Working Group, established that notice should be given in written or electronic form under the draft instrument.

*Parties who must send and receive the notice*

73. Concern was raised with respect to the phrase in square brackets that notice must be given “[by or on behalf of the consignee]”. It was observed that this requirement, if accepted by the Working Group, might unnecessarily restrict the category of parties who could provide notice of loss or damage. In addition, it was suggested that the parties to whom notice could be provided should be expanded from “the carrier or the performing party” to include the agents of the carrier or performing party. There was some support for these suggestions.

74. It was observed that notice under paragraph 1 must be given to the carrier or the performing party, but that the network system in the draft instrument envisaged that rules other than those set forth in the draft instrument could apply for the notice of loss, damage or delay with respect to the land leg of a particular contract of carriage. It was proposed that it would thus be appropriate to include in draft article 20 a rule as follows: “The form and time limit prescribed for the notice of damage shall be deemed to have been observed as well if the corresponding provisions which would be applicable to a contract of carriage covering the last leg of the carriage have been complied with.” There was some support in favour of that proposal. In opposition, it was stated that the issue of notice periods in inland transport conventions was linked to their liability systems and ought not be taken out of that context. Since paragraph 1 had limited legal consequences, it should not be unnecessarily complicated. In addition, it was noted that a seven-day notice period, if finally retained, would be helpful in avoiding confusion, since it would be similar to the notice period required in certain road transport instruments such as CMR.

*Conclusions reached by the Working Group on paragraph 1*

75. After discussion, the Working Group decided that:

- The original text and the proposed redraft of paragraph 1 should be placed in square brackets for future discussion;

- The words “a reasonable time” should be deleted from the original version of paragraph 1;
- Seven days was an appropriate notice period and should be inserted into the original version of paragraph 1, with the words “seven consecutive days” and “seven working days” appearing as alternatives in square brackets.

## Paragraph 2

### *Differences between paragraphs 1 and 2*

76. Concerns were expressed with respect to the difference in treatment accorded to failure to give notice under paragraph 1 and under paragraph 2. It was suggested that barring a claim for loss due to delay on the grounds of failure to give notice within 21 days was particularly harsh in light of the fact that the carrier would already benefit from the low limitation on damages for delay of one times the freight payable pursuant to paragraph 16 (2). It was also suggested that the draft convention already contained provisions on the time for suit, and that it would be unreasonable to bar a claim in the circumstances set out in paragraph 2. It was noted in response that the approach in paragraph 1 was intended to deal with notice of non-apparent loss, which was discoverable upon examination of the goods, and which was in all parties' interest to be made in as short a delay as possible. However, in the situation covered by paragraph 2, all parties would know quickly of the delay, but the missing information was with respect to the consequential damages claimed as a result of the loss for delay. It was suggested that the longer notice period was reasonable in order to determine the existence of consequential damages, which could be difficult to ascertain, and to provide notice of them. In addition, it was noted that CMR accorded the same treatment for failure to notice of loss due to delay within the specified time limit.

### *“such loss”*

77. It was suggested that the notice required should be notice of the delay rather than notice of the loss. However, it was noted that the fact of the delay would be known by the parties very quickly, and that the important factor for the carrier was to have some certainty regarding the legal consequences of the delay and the economic loss resulting therefrom for which it could be liable. It was suggested that it would be difficult for the claimant to ascertain the extent of its consequential loss due to delay, but it was noted that the notice required was notice of the loss rather than the details of the claim. A proposal was made to delete the word “such” from this phrase in order to clarify the contents of the notice, or to make specific reference to paragraph 16 (2) to clarify that reference was being made to economic loss. It was suggested that simply using the word “loss” would be insufficient to indicate that reference was being made to loss occasioned by delay. Support was expressed for substituting the phrase “loss due to delay” for the phrase “such loss”.

### *“the person against whom liability is being asserted”*

78. It was noted that paragraph 1 provided for notice to the carrier or to the performing party, while paragraph 2 required notice to “the person against whom liability is being asserted”. It was suggested that this language was intended to encourage the claimant to decide at an early stage who to sue, keeping in mind that

multiple parties could be notified, in order to provide certainty to the potential defendants to the claim. However, there was support for the view that this language could unfairly limit the claimant in pursuing a claim, since it was not clear whether it would be possible to sue a party to whom notice was not provided. There was support for the suggestion that the word “carrier” should be substituted for the phrase “the person against whom liability is being asserted”.

#### *Time period*

79. It was noted that the Hamburg Rules provided in article 19 (5) a 60-day notice period for notice of loss resulting from delay. It was suggested that 21 days was a suitable period of time in which to require notice in order to both provide certainty for the carrier and allow an assessment of the extent of its potential liability. It was also noted that the 21 day time period in paragraph 2 was identical to the time period provided in the CMR for notice of loss due to delay.

#### *“delivery”*

80. It was suggested that it should be made clear in paragraph 2 that the “delivery” should be delivery pursuant to the contract.

#### *Conclusions reached by the Working Group on paragraph 2*

81. After discussion, the Working Group decided that:

- The phrase “the person against whom liability is being asserted” should be replaced by the words “the carrier”;
- The phrase “loss due to delay” should be substituted for the phrase “such loss”, taking care that there is consistency in the translation of the word “loss” in all language versions.

### **Paragraph 3**

#### *Drafting correction*

82. It was agreed that the phrase in paragraph 3 “in this chapter” should be revised to “in this article”.

#### *“notice given to a performing party”*

83. There was support for the suggestion that the second reference to “performing party” in the closing phrase of this paragraph should instead make reference to “maritime performing party” in order to take into account the agreement of the Working Group to limit the application of the draft instrument to maritime performing parties. It was thought that to do otherwise would impose upon performing parties the burden of receiving notice under the draft instrument. In response, the suggestion was made that it was clear that the paragraph was referring only to notice under the draft instrument, and not under some other transport convention. It was noted that if the change were made to maritime performing parties, the phrase should read “a” or “any” maritime performing party, and that the phrase “that delivered the goods” would likely no longer be necessary.



*Conclusions reached by the Working Group on paragraph 3*

84. After discussion, the Working Group decided that the Secretariat should prepare a revised draft of this paragraph, taking into consideration whether the change should be made to “maritime performing party” in the closing phrase of the paragraph, and whether further language adjustments should be made in that regard.

**Paragraph 4***General discussion*

85. It was suggested that paragraph 4 should be deleted and that arrangements for access and inspection should be left to cooperation between the parties or to national law. However, it was noted that this provision served an important purpose and was drawn from the Hague and Hague-Visby Rules, and support was expressed for maintaining the paragraph.

“*[for][must provide]*”

86. It was suggested that the word “[for]” should be deleted and the phrase “[must provide]” should be maintained, without square brackets.

*Conclusions reached by the Working Group on paragraph 4*

87. After discussion, the Working Group decided that paragraph 4 would be maintained, with the word “[for]” deleted and the phrase “must provide” maintained, without square brackets.

**Draft article 21. Non-contractual claims**

88. The Working Group considered the text of draft article 21 as contained in document A/CN.9/WG.III/WP.32.

*Drafting matters*

89. It was agreed that reference in this draft article to “performing party” should be revised to “maritime performing party”. Further, it was noted that the phrase “in connection with” (as discussed in paras. 42 and 58 above) also appeared in draft article 21.

*Interaction with paragraph 15 (4)*

90. It was suggested that this paragraph was a duplication of paragraph 15 (4) in A/CN.9/WG.III/WP.36, and that article 21 should be deleted as being repetitious. In response, it was noted that paragraph 15 (4) was intended to provide so-called Himalaya protection for servants and agents of the carrier, while draft article 21 extended the defences and limits of liability in the draft instrument to non-contractual claims.

*Conclusions reached by the Working Group on paragraph 4*

91. After discussion, the Working Group decided that:

- The word “maritime” should be added to the phrase “performing parties”;

- The Secretariat should consider whether paragraph 15 (4) and draft article 21 were repetitious and, if not, whether they should be consolidated, given their close relationship;
- The Secretariat should include this draft article in its consideration of the phrase “in connection with” throughout the draft instrument.

## Chapter 6: Additional provisions relating to carriage by sea

### Draft article 22. Liability of the carrier

92. The Working Group considered the text of draft article 22 as contained in document A/CN.9/WG.III/WP.32.

#### *Placement*

93. There was general agreement that the contents of draft article 22 might need to be moved to draft article 14 as a result of the deliberations of the Working Group at its twelfth session.

#### *The fire exception*

94. Strong support was expressed for the deletion of a specific fire exception. It was stated that no special treatment of the issue of fire was necessary in modern navigation. It was also pointed out that it would be particularly appropriate to deal with fire through the general rule set forth in draft article 14, since in most instances, the carrier would be better placed to identify the causes of the fire. However, strong support was also expressed for retaining the traditional fire exception to avoid altering the general balance of interests in the draft instrument. It was stated that the elimination of the exception drawn from the error in navigation had already compromised that balance. In that connection, it was suggested that the latter exception should be reinstated in the draft instrument, at least to cover the error in navigation made in the context of mandatory pilotage (see A/CN.9/WG.III/WP.28). That suggestion received little support.

95. As to how the fire exception might be formulated, it was suggested that the reference to the “fault or privity of the carrier” should be replaced by a reference to the “fault or privity of the carrier, its servants or agents”. It was observed that the issue might need to be further discussed in the context of draft article 14.

#### *Salvage of property at sea*

96. Doubts were expressed as to whether the salvage or attempted salvage of property at sea should be treated on the same footing as the salvage or attempted salvage of life at sea. Broad support was expressed for the introduction of a test of reasonableness along the lines of “reasonable measures to save or attempt to save property at sea”. It was pointed out that the salvage of property at sea might entail considerable remuneration for the carrier, with no direct or automatic impact on the damaged cargo.

*Reasonable attempt to avoid damage to the environment*

97. In the context of the discussion regarding the salvage or attempted salvage of property at sea, it was suggested that special mention should be made in the draft instrument of a cause of exoneration that should result from a reasonable attempt to avoid damage to the environment. Broad support was expressed for that suggestion.

*Perils of the sea*

98. The Working Group was generally in agreement with the substance of the rule on “perils, dangers and accidents of the sea or other navigable waters”.

*Conclusions reached by the Working Group on draft article 22*

99. After discussion, the Working Group decided that:
- The fire exception would be maintained in the draft instrument and further considered in the context of draft article 14;
  - The words “saving or attempting to save property at sea” should be replaced by words along the lines of “reasonable measures to save or attempt to save property at sea”, possibly as a separate subparagraph;
  - Words along the lines of “reasonable attempt to avoid damage to the environment” should be introduced in the draft instrument, possibly as a separate subparagraph;
  - The Secretariat would be requested to prepare a revised draft merging draft article 22 with draft article 14 as amended at the twelfth session of the Working Group.

**Draft article 23. Deviation**

100. The Working Group considered the text of draft article 23 as contained in document A/CN.9/WG.III/WP.32.

*General discussion*

101. Doubts were expressed regarding the usefulness of draft article 23 in many legal systems. However, it was explained that under existing case law in certain countries, a provision along the lines of draft article 23 was necessary to avoid deviation being treated as a major breach of the carrier’s obligations. That explanation met with the general approval of the Working Group. With a view to providing a more complete treatment of the issue of deviation, the attention of the Working Group was drawn to a proposal for a revision of draft article 23 contained in document A/CN.9/WG.III/WP.34, paragraph 38. In particular, that proposal was intended to clarify that the only deviation for which the carrier could be held liable was an “unreasonable” deviation and that this concept would relate only to the routing of an ocean-going vessel (operated by the carrier or a performing party). While support was expressed with respect to both the current text of draft article 23 and the proposed revision, the view was expressed that further consultations were necessary before a formulation of the provision on deviation could be agreed upon.

*Conclusions reached by the Working Group on draft article 23*

102. After discussion, the Working Group decided that the current text of draft article 23, together with the alternative text proposed in document A/CN.9/WG.III/WP.34, paragraph 38 would be placed in square brackets in the draft instrument for continuation of the discussion at a future session.

**Draft article 24. Deck cargo**

103. The Working Group considered the text of draft article 24 as contained in document A/CN.9/WG.III/WP.32.

**Paragraph 1**

*“(b) ... containers on decks that are specially fitted to carry such containers”*

104. It was suggested that subparagraph (b) specify that the containers for carriage on deck should be “closed containers” or “containers fitted to carry cargo on deck” since the definition of container in draft article 1 (s) was very broad. It was pointed out in response that various types of semi-closed containers were used for on-deck carriage. A question was raised whether subparagraph (b) was necessary at all, since it would appear to be subsumed by the reference in subparagraph (c) to carriage on deck in compliance “with the customs, usages, and practices of the trade”. It was suggested, however, that the two separate categories in subparagraphs (b) and (c) were necessary to reflect various industry practices that might entail different legal consequences.

*“(c) ... in accordance with the contract of carriage”*

105. Questions were raised concerning the agreement necessary to approve carriage on deck in the contract of carriage, specifically whether mention of it in the bill of lading was sufficient, or whether express agreement was necessary. It was suggested that this question could be more easily answered after the Working Group had had its discussion on freedom of contract issues.

*Conclusions reached by the Working Group on paragraph 1*

106. After discussion, the Working Group decided that:

- In subparagraph (b), the word “containers” should be replaced by the phrase “containers fitted to carry cargo on deck”, to be placed between square brackets for continuation of the discussion;
- Square brackets should be inserted around the phrase “in cases not covered by paragraphs (a) or (b) of this article” in subparagraph (c);
- Square brackets should be inserted around the phrase “in accordance with the contract of carriage” in subparagraph (c).

**Paragraph 2***General discussion*

107. There was general agreement with the principle of the rule enunciated in paragraph 2. It was also agreed that the opening phrase of paragraph 2 should read

“... in accordance with paragraphs 1 (a) or (c)”, rather than “... in accordance with paragraphs 1 (a) and (c)”.

*Interaction with draft article 14 on burden of proof and concurrent causation*

108. Questions were raised concerning the interaction of paragraph 2 with draft article 14 (A/CN.9/WG.III/WP.36). It was noted that paragraph 2 derogated from draft article 14 and placed the burden of proof of the damage on the carrier. Despite this derogation, it was stated that the liability of the carrier for loss, damage or delay “that are exclusively the consequence” of the carriage of the goods on deck, might raise a difficult question in connection with the rule on concurrent causation in draft article 14 (4).

*Conclusions reached by the Working Group on paragraph 2*

109. After discussion, the Working Group decided that:

- The text of paragraph 2 would be corrected by replacing the word “and” with the word “or” in its opening phrase;
- Paragraph 2 would be discussed in greater detail in conjunction with draft article 14 (4).

### **Paragraph 3**

*General remarks*

110. While the thrust of paragraph 3 was generally acceptable, a widely shared view was that the issue of third party rights should be further discussed in the context of chapter 11 (right of control) and chapter 12 (transfer of rights). It was observed that the pending discussion on freedom of contract would also have a bearing on the issue of third party rights. A suggestion was made that paragraph 3 should also apply to the situation where a third party has relied on a non-negotiable transport document or electronic record, since the issue should be the reliance on the document or record rather than its legal contents.

*Conclusions reached by the Working Group on paragraph 3*

111. After discussion, the Working Group decided that it would reopen discussion of paragraph 3 generally, and of whether it should be expanded to cover third-party reliance on non-negotiable transport documents and electronic records after it had discussed the broader issues of third-party rights and freedom of contract under the draft instrument.

### **Paragraph 4**

*“if the carrier and shipper expressly have agreed”*

112. A question was raised as to why express agreement between the shipper and the carrier to carry the goods below deck was necessary to break the liability limit for damage caused by on-deck carriage, when the general approach was that the goods should be carried below deck except in the situations outlined in paragraph 1. It was stated in response that only the breach of an express agreement to carry containers below deck should result in loss of the right to limit liability of the

carrier under paragraph 4 for incurring the damage specifically intended to be avoided.

*“that exclusively resulted from their carriage on deck”*

113. It was suggested that when the carrier carried the goods above deck contrary to an express agreement to carry the goods below deck, any damage caused by the deck carriage was the result of a reckless act under draft article 19, and the carrier should thus lose the right to limit its liability. It was proposed that, therefore, the phrase “that exclusively resulted from their carriage on deck” should be deleted. There was support for that proposal.

114. However, several delegations expressed the view that the reckless or intentional behaviour dealt with under draft article 19 differed markedly from the situation covered in paragraph 4 in terms of the intent to cause loss or damage to the goods. An example was given that loss of an entire ship should not result in the loss by the carrier of its limitation regarding carriage on deck, since there was no causal connection between the improper deck carriage and the loss of the cargo. There was some support for the suggestion that paragraph 4 be retained in its current form.

115. A third proposal was made to delete only the word “exclusively”. It was thought that this might broaden somewhat the potential liability of the carrier, thus recognizing the serious nature of the carrier’s failure to respect the express agreement to carry the goods below deck. Some support was also expressed for that proposal.

#### *Deletion of paragraph 4*

116. A fourth proposal was made to delete paragraph 4 in its entirety, particularly if draft article 19 could be said to cover the circumstances dealt with in paragraph 4. This proposal met with somewhat less support than the other three proposals with respect to this paragraph.

#### *Conclusions reached by the Working Group on paragraph 4*

117. After discussion, the Working Group decided that:

- The word “expressly” should be retained in square brackets;
- Square brackets should be placed around the phrase “that exclusively resulted from their carriage on deck”;
- Square brackets should also be placed around the word “exclusively”;
- Square brackets should be placed around paragraph 4 in its entirety;
- The discussion of paragraph 4 would need to be reopened at a future session and its relationship with draft article 19 should be further studied.

## **Chapter 7: Obligations of the shipper**

### **Draft article 25**

118. The Working Group considered the text of draft article 25 as contained in document A/CN.9/WG.III/WP.32.

*“[Subject to the provisions of the contract of carriage,]”*

119. It was widely felt that a reference to the contract of carriage should be made in draft article 25. However, the view was expressed that the current reference was misplaced. Under that view, the obligation of a shipper to deliver the goods ready for carriage could be deviated from by agreement between the shipper and the carrier, where, for example, the carrier agreed to use its equipment to position a shipper's goods in order to ready them for carriage, but that a shipper should not be able to contract out of its obligation to prepare the goods to withstand the intended carriage. It was suggested that, therefore, the phrase in square brackets should be deleted, and the phrase “unless otherwise agreed, and” should be added after the phrase “the shipper shall deliver the goods ready for carriage”. There were no specific objections to this suggestion, provided that the intention of the language originally in the square brackets continued to be reflected in the draft article. A further proposal in this vein was to delete the language in square brackets, but to insert after the opening phrase of draft article 25, “[t]he shipper shall”, the phrase employed regarding the obligations of the carrier in draft article 10, “in accordance with the terms of the contract of carriage”.

120. The suggestion was made that the phrase in square brackets could be deleted entirely from draft article 25 in order to avoid the possible inference that it would be possible to increase the obligations of the shipper through contractual agreement. However, there was strong support for the retention of the draft article and of the principle expressed in the phrase in square brackets.

#### *Regulations concerning safety and the environment*

121. It was suggested that draft article 25 should acknowledge existing regulations in place for the safety of the transport or carriage by including language such as “without prejudice to regulations regarding safety”. A similar proposal was made with respect to the protection of the environment.

#### *Second sentence of draft article 25*

122. It was proposed that the second sentence of draft article 25 should be deleted as unnecessarily repetitious of the obligations of the shipper set out in the first sentence. However, concern was expressed that, while it might be desirable to improve the language in the second sentence, the container rule expressed therein was a separate obligation that should be maintained in the draft article. There was support for this position.

#### *Conclusions reached by the Working Group on draft article 25*

123. After discussion, the Working Group decided that:

- Draft article 25 should be retained in the draft instrument;
- The principle appearing in square brackets that the obligations of the shipper should be subject to the contract of carriage should be maintained, and the brackets deleted, but the Secretariat should consider redrafting this provision

in appropriate language in light of the discussion in the Working Group and the suggested proposals;

- The Secretariat might consider possible improvements to the wording of the second sentence, while retaining its meaning.

## **Draft article 26**

124. The Working Group considered the text of draft article 26 as contained in document A/CN.9/WG.III/WP.32.

### *General discussion*

125. Suggestions were made for the deletion of draft article 26, with or without deletion of draft article 25. Another suggestion was that draft article 26 should be merged with draft article 28. The prevailing view was that the substance of draft article 26 should be retained to balance the obligations set forth in draft article 25 in respect of the shipper.

### *Placement*

126. For reasons already stated at the ninth session of the Working Group, doubts were expressed regarding the placement of draft article 26 in a chapter dealing with the obligations of the shipper (see A/CN.9/510, paras. 149-151). The prevailing view was that draft article 26 was appropriately located as a logical complement to draft article 25. To remedy the apparent inconsistency created by the presence of a provision dealing with an obligation of the carrier in a chapter dealing with the obligations of the shipper, it was generally agreed that titles should be given to the draft articles in chapter 7. A suggestion was made that the title of chapter 7 might also be revised along the lines of "Obligations of the shipper and ancillary matters".

### *"on its request"*

127. While the view was expressed that the obligations set forth in draft article 26 were formulated too subjectively (for example, by referring to instructions "that are reasonably necessary or of importance to the shipper"), the discussion focused on whether the carrier should provide information "on request" by the shipper.

128. Several delegations expressed support for deletion of the words "on its request". It was explained that the carrier should be expected to take the initiative of providing the shipper with "reasonably necessary" information in view of the nature of the cargo. In response, it was pointed out that the nature of the cargo might not always be known to the carrier and that, in view of the onerous liability created by draft article 29 for failure to comply with draft article 26, the obligations of the carrier under the latter provision should only be triggered by a specific request of the shipper. As a possible alternative for the words "at its request", it was suggested that wording inspired from draft article 27 might be introduced in draft article 26 along the lines of "unless the carrier may reasonably assume that such information is already known to the shipper".



*Conclusions reached by the Working Group on draft article 26*

129. After discussion, the Working Group decided that:

- The Secretariat should make proposals for titles of the draft articles in chapter 7;
- The substance of draft article 26 should be retained in chapter 7, including the words “at its request” for continuation of the discussion at a future session;
- Further consideration might need to be given to the above-suggested alternative wording.

**Draft article 27**

130. The Working Group considered the text of draft article 27 as contained in document A/CN.9/WG.III/WP.32.

*General discussion*

131. Support was expressed for the deletion of subparagraph (c), which was said to have little in common with subparagraphs (a) and (b) or with the obligations of the shipper. In support of deletion, it was explained that the issues addressed in subparagraph (c) were sufficiently dealt with in chapters 8 (documentation) and 10 (designation of the consignee). However, the Working Group was urged to exercise utmost caution in deleting a provision that was inspired from the Hague Rules and might not be sufficiently covered in chapters 8 and 10. It was generally agreed that the possible relationship of subparagraph (c) with chapters 8 and 10 might require further consideration at a future session.

132. Support was also expressed for the view that the closing words of subparagraph (c) (“unless the shipper may reasonably assume that such information is already known to the carrier”) should apply to subparagraphs (a) and (b). In respect of subparagraph (b), however, the prevailing view was that the obligation to provide accurate instructions and the documents necessary for compliance with regulations and other requirements of public authorities was distinct from the obligation to provide information under subparagraph (a), should avoid any ambiguity in view of the public policy considerations on which it was based, and, for those reasons, should not depend upon an assessment of what might or might not be known to the carrier.

*Conclusions reached by the Working Group on draft article 27*

133. After discussion, the Working Group decided that:

- The general structure of draft article 27 was acceptable;
- The current text of the draft article, including its three subparagraphs, should be maintained for continuation of the discussion at a future session;
- The words “unless the shipper may reasonably assume that such information is already known to the carrier” should be added at the end of subparagraph (a).

## Draft article 28

134. The Working Group considered the text of draft article 28 as contained in document A/CN.9/WG.III/WP.32.

### *Deletion of draft article 28*

135. With a view to simplifying the text of the draft instrument, it was suggested that draft article 28 should be deleted and its operative intent (that the information, instructions and documents provided by the shipper and the carrier to each other should be accurate and complete, and given in a timely manner) should be reflected directly in draft articles 26 and 27. While the view was expressed that the ideas of accuracy and completeness of the information were implicit in the obligation to provide information established by draft articles 26 and 27, it was widely felt that, for practical reasons and in view of the frequency of misrepresentation in transport information and documentation, it might be necessary to include express reference to “accuracy and completeness” in both draft articles 26 and 27.

136. Broad support was expressed in favour of the simpler draft that might result from the deletion of draft article 28. Doubts were expressed, however, regarding the substance of the obligation to provide “accurate and complete” information and instructions. It was explained that a possible conflict might exist, for example, between the subjective notion of instructions being “reasonably necessary or of importance to” the shipper or the carrier and the more objective notion of such instructions being “complete”. It was generally agreed that the issue might need to be further discussed after the nature of the liabilities of the shipper and the carrier in draft articles 29 and 30 had been clarified.

### *Conclusions reached by the Working Group on draft article 28*

137. After discussion, the Working Group decided that:

- Draft article 28 would be deleted and replaced by a mention in draft article 26 that the shipper should provide “in a timely manner” the information and instructions required and that “the information and instructions given must be accurate and complete”; similarly, draft article 27 should be amended to read that the shipper should provide to the carrier “in a timely manner, such accurate and complete information, instructions and documents ...”;
- The above amendments to draft articles 26 and 27 should be placed between square brackets for continuation of the discussion after liabilities of the shipper and the carrier under draft articles 29 and 30 had been considered.

## Draft articles 29 and 30

138. The Working Group considered the text of draft articles 29 and 30 as contained in document A/CN.9/WG.III/WP.32.

### *Proposal for a revision of draft articles 29 and 30*

139. A proposal was made for the replacement of draft articles 29 and 30 by a provision along the following lines:

“1. Subject to articles 25, 27 and 28 the shipper is liable for damage or loss sustained by the carrier or a sub-carrier that the shipper has caused intentionally or by its fault or neglect.”

“2. If the shipper has delivered dangerous goods to the carrier or the sub-carrier without informing the carrier or sub-carrier of the dangerous nature of the goods and of necessary safety measures, and if the carrier did not otherwise have knowledge of the dangerous nature of the goods and the necessary safety measures to be taken, the shipper is responsible for the damage or loss sustained by the carrier.”

140. By way of explanation, it was stated that the shipper should be liable for damages it had caused to the carrier through fault or negligence. The proposed text was said to introduce a balance between the carrier's and the shipper's liabilities. Paragraph 2 of the proposed text was intended to establish a strict (no-fault) liability of the shipper for not informing the carrier of the dangerous nature of certain goods. As to the liabilities of the shipper to the consignee and the controlling party, it was suggested that these should be dealt with by reference to the contractual arrangements between the parties or to the law applicable outside the draft instrument, respectively. It was pointed out that the proposal was based on the assumption that any provision dealing with the liability of the carrier in the current text of draft articles 29 and 30 would need to be further considered in the context of (and possibly added to) the provisions of the draft instrument dealing more generally with the obligations of the carrier. The view was expressed that the sanction of a breach by the carrier of its obligation under article 26 should not be a liability but a loss of the carrier's right to invoke article 25.

141. While it was generally agreed that the text of the proposal might need to be improved, in particular to avoid ambiguities regarding the identity of “the sub-carrier”, the Working Group based its deliberations on the principles reflected in the proposal.

*Principle of the shipper's liability being based on fault*

142. Strong support was expressed for the principle that the liability regime applied to the shipper should be generally based on fault, thus mirroring the liability regime established by the draft instrument in respect of the carrier. As to possible cases where it might be necessary to hold the shipper strictly liable, the following exceptions to the general principle were suggested:

- The cases covered by subparagraph (c) of draft article 27 (information necessary for the carrier to establish the transport documents), which were already dealt with by way of strict liability in article III.5 of the Hague-Visby Rules;
- The cases covered by subparagraph (b) of draft article 27 (information required to allow the carrier to comply with regulations or requirements of public authorities).

143. As to the formulation of the above exceptions, it was widely felt that the phrase “subject to articles 26, 27 and 28” in the proposal might need to be amended, not only to specify the individual exceptions but also to clarify that, to be held

strictly liable under this provision, the shipper should be in breach of its obligation to provide the carrier with the necessary information, instructions or documents.

*Shipper's liability to the consignee or the controlling party*

144. For the reasons put forward by the proponents of the text intended for the replacement of draft articles 29 and 30, support was expressed for not dealing with the liability of the shipper to the consignee. The view was expressed, however, that the provisions dealing with the liability of the shipper should mirror the structure of the provisions dealing with the liability of the carrier, and the issue of liability to the consignee and the controlling party might need to be reconsidered at a later stage.

*Joint liability*

145. Support was expressed for retaining paragraph 3 of variant B of the initial text of article 29 for continuation of the discussion at a later stage on the issue of joint liability, which was not dealt with in the proposal. It was suggested that, should a provision on joint liability be eventually retained in the draft instrument, a provision regulating the exercise of recourse actions might be needed.

*Dangerous goods*

146. As to the substance of the proposal under which the shipper should be held strictly liable to inform the carrier of the dangerous nature of the goods and of the necessary safety measures, a concern was expressed that the proposed rule might be unnecessary and its effect uncertain, unpredictable, and overly onerous for the shipper, particularly in view of existing case law in a number of countries, under which goods, although not identifiable as dangerous before the carriage could later be declared dangerous by courts adjudicating the claim, for the sole reason that they had caused damage. The view was expressed that the issue of dangerous goods was sufficiently covered in the draft instrument, for example in draft articles 27 and 12, which appropriately avoided using the notion of "dangerous goods" itself. Additional views were that the issue of dangerous goods might be dealt with by reference to article 13 (2) of the Hamburg Rules or through the insertion in draft article 27 of an obligation of the shipper to inform the carrier of the dangerous nature of the goods.

147. The discussion focused on the definition of dangerous goods. It was generally felt that, should a provision expressly referring to the notion of dangerous goods be retained, a definition should be provided in the draft instrument. The only possible reference was said to be the definition provided in the International Convention on Liability and Compensation for Damage in Connection with the Carriage of Hazardous and Noxious Substances (HNS) by Sea but considerable doubts were expressed regarding the appropriateness of introducing such a definition in an international trade law instrument. Support was expressed for addressing in the definition the issue of goods that became dangerous during the carriage.

*Conclusions reached by the Working Group on draft articles 29 and 30*

148. After discussion, the Working Group decided that:

- The aspects of draft articles 29 and 30 dealing with the liability of the carrier should be moved for continuation of the discussion under those provisions that dealt specifically with the obligations of the carrier;
- Draft articles 29 and 30 should be redrafted entirely to reflect the general principle that the liability of the shipper should be based on fault;
- Exceptions to that general principle should be made and a rule of strict liability retained in cases where the shipper failed to meet the requirements of subparagraphs (b) and (c) of draft article 27; such exceptions should be placed between square brackets;
- As a further option, a provision similar to article III.5 of the Hague Rules should also be introduced in square brackets;
- Paragraph 3 of Variant B of draft article 29 (A/CN.9/WG.III/WP.32) should be retained for continuation of the discussion at a future session;
- A specific provision should be inserted at an appropriate place in the draft instrument to deal with the issue of dangerous goods, based on the principle of strict liability of the shipper for insufficient or defective information regarding the nature of the goods;
- A broad definition of the notion of “dangerous goods” should be provided; in drafting such a definition, the Secretariat was requested to bear in mind other existing international transport instruments and to address the issue of goods that became dangerous during the carriage.

### **Draft article 29 bis**

149. The Working Group considered a proposal for the introduction of a draft article 29 bis in the draft instrument (A/CN.9/WG.III/WP.34, para. 43).

#### *Causation*

150. Questions were raised concerning the breadth of draft article 29 bis. It was suggested that the carrier should only be excused from liability for delay of, loss of, or damage to the goods that was caused by the material misstatement of the shipper. It was observed that lack of causality in the proposed draft article was not an innovation, and reference was made to the corresponding provision in article IV.5.h of the Hague-Visby Rules. The prevailing view was that draft article 29 bis contained a well-known provision that dealt with an important matter, and that it should be included in the text in square brackets in order to reflect the reservations expressed with respect to causation.

#### *Delay*

151. Questions were raised concerning the inclusion in draft article 29 bis of damages resulting from delay, particularly since the corresponding provision of the Hague-Visby Rules did not include damages for delay. The prevailing view was that the square brackets around the text would also reflect the reservations expressed with respect to the inclusion of damage for delay.

*Placement*

152. The view was expressed that consideration should be given to the possibility that draft article 14 might already govern situations of material misstatement by the shipper. It was agreed that the Secretariat would consider draft article 14 in deciding where best to locate draft article 29 bis in the draft instrument.

*Conclusions reached by the Working Group on draft article 29 bis*

153. After discussion, the Working Group decided that:

- The text of draft article 29 bis should be included in the draft instrument in square brackets;
- The issues of causation and the inclusion of damages for delay would be discussed at a future session;
- The Secretariat would consider placing draft article 29 bis in chapter 5 on the liability of the carrier.

**Draft article 31**

154. The Working Group considered the text of draft article 31 as contained in document A/CN.9/WG.III/WP.32.

*General discussion*

155. The Working Group was reminded that, of the three possible types of shippers, the documentary shipper, the contractual shipper and the actual shipper, draft article 31 was intended to deal with the position of the f.o.b. seller who was named as the shipper in the transport document (see A/CN.9/510, para. 164 and A/CN.9/WG.III/WP.21, paras. 118-122). Further, it was noted that, generally speaking, this provision was intended to mirror the identity of the carrier provision in paragraph 36 (3), and there was some suggestion that perhaps that paragraph and this provision should be aligned. It was generally agreed that the most common situation that was likely to arise under draft article 31 was where a request would be made to change the name of the shipper in the transport document. In addition, it was also agreed that further investigations should be conducted to determine whether the problem of failing to name any shipper in the transport document was sufficiently common to warrant consideration in this provision.

*“subject to the responsibilities and liabilities imposed on the shipper”*

156. Questions were raised whether the intention of draft article 31 was that the responsibilities and liabilities of the contractual shipper would pass to the actual or documentary shipper, or whether the intention was that there would be joint liability. In response, it was noted that the intention of draft article 31 was to impose the responsibilities and liabilities on the documentary shipper not instead of, but in addition to, the contractual shipper. Further concerns were raised regarding whether it was appropriate that the documentary shipper should be subject to all of the responsibilities and liabilities imposed on the contractual shipper. It was suggested that it might be preferable to apply draft article 31 only in cases where the identity

of the contractual shipper was unknown, taking care to ensure that the documentary shipper should be liable for providing false or inaccurate information whether or not the contractual shipper was known. The prevailing view was that square brackets should be inserted around the phrase “subject to the responsibilities and liabilities” pending further consideration of the concerns raised in the context of this draft article.

*“accepts the transport document or electronic record”*

157. Concern was expressed that the use of the word “accepts” was imprecise and allowed too broad an interpretation of the draft provision. While it was noted that the word “accepts” accurately reflected the situation where the documentary shipper became the first holder in the case of negotiable instruments, it was suggested that another word, such as “receives” might be preferable in terms of raising fewer concerns. The prevailing view was that the words “accepts” and “receives” should be placed in square brackets in the text.

*Conclusions reached by the Working Group on draft article 31*

158. After discussion, the Working Group decided that:

- The general intention of draft article 31 was acceptable, but that further thought should be given to the precise ambit of the provision, and whether it should only be a default rule where the identity of the contractual shipper was not known;
- The phrase “subject to the responsibilities and liabilities” should be placed in square brackets;
- The word “accepts” should be placed in square brackets for future discussion, together with the word “receives”.

## **Draft article 32**

159. The Working Group considered the text of draft article 32 as contained in document A/CN.9/WG.III/WP.32.

*General discussion*

160. It was agreed that there was a need for a provision such as draft article 32 in the draft instrument. It was observed that draft article 32 was intended to mirror the text of paragraph 15 (3) (A/CN.9/WG.III/WP.36) regarding the liability of a performing party for the acts and omissions of any person to whom it had delegated the performance of any of the carrier’s responsibilities under the contract of carriage, and that, in fact the two provisions used virtually identical language. Some concern was expressed regarding the persons who could be included in draft article 32, but it was suggested that the phrase “any person to which [the shipper] has delegated the performance of any of its responsibilities under this chapter” made the category of persons to whom it applied sufficiently clear. Concern was also expressed whether draft article 32 was sufficiently clear regarding the general rule that the liability of the shipper should be based on fault, but it was suggested that the phrase “as if such acts or omissions were its own” sufficiently clarified the basis

on which liability would be assessed. The prevailing view was that the text of draft article 32 should be retained as drafted.

*Conclusions reached by the Working Group on draft article 32*

161. After discussion, the Working Group decided that:

- The general structure of draft article 32 was acceptable and the current text should be maintained for future discussion;
- Questions raised regarding the interaction of this provision with paragraph 11 (2) and draft article 29 bis should be considered at a future session.

## **Chapter 9: Freight**

162. The Working Group considered the text of chapter 9 as contained in document A/CN.9/WG.III/WP.32.

*General discussion*

163. It was suggested that chapter 9 on freight was a non-mandatory regulation that dealt with purely commercial matters, and that it should be deleted. In response, it was observed that while chapter 9 was non-mandatory, its provisions could be helpful to fill gaps left by commercial parties in their agreements. It was further observed that some of the provisions contained in chapter 9 were not, strictly speaking, devoted solely to the issue of freight: paragraph 43 (2) dealt with the cessation of the shipper's liabilities and the transfer of rights; the "freight prepaid" provision in the opening two sentences of paragraph 44 (1) was intended to provide protection and clarity for third party holders of a transport document; and draft article 45 was an attempt to bring some uniformity to the subject of liens. It was suggested that given that these provisions contained important rules while only incidentally touching on freight, they should be retained for future consideration despite the general desire to delete the chapter on freight. There was general agreement with this approach, except with respect to draft article 45, which, it was suggested, was too complex and dealt with a subject matter too diverse to lend itself to uniform legislation, and should be left to applicable law. The prevailing view favoured deletion of chapter 9 in its entirety, but it was generally agreed that draft article 43 (2) and the first two sentences of draft article 44 (1) should be maintained (and placed elsewhere in the draft instrument) for future consideration by the Working Group.

*Conclusions reached by the Working Group on chapter 9*

164. After discussion, the Working Group decided that chapter 9 should be deleted. Draft article 43 (2) and the first two sentences of draft article 44 (1) should be retained in square brackets and placed by the Secretariat in an appropriate location in the draft instrument for further discussion at a future session.



### III. Other business

#### *Scheduling of fourteenth session*

165. It was noted that, subject to approval by the Commission at its the thirty-seventh session (New York, 14-25 June 2004), the fourteenth session of the Working Group would be held in Vienna, at the Vienna International Centre, from 29 November to 10 December 2004.

#### *Planning of future work*

166. With a view to structuring the discussion on the remaining provisions of the draft instrument the Working Group adopted the following tentative agenda for completion of its second reading of the draft instrument:

##### *- Fourteenth session*

Liability of the carrier (draft articles 14, 22 and 23);  
Freedom of contract (draft articles 2, 88 and 89);  
Jurisdiction and arbitration (draft articles 72-80 bis);

##### *- Fifteenth session (New York, Spring 2005)*

Transport documents/electronic commerce (draft articles 3-6 and 33-40);  
Right of control and transfer of rights (draft articles 53-61);  
Delivery of goods (draft articles 46-52);  
Right and time for suit (draft articles 63-71).

#### *Methods of work*

167. The Working Group was informed that, with a view to accelerating the exchange of views, the formulation of proposals and the emergence of consensus in preparation for a third and final reading of the draft instrument, a number of delegations had taken the initiative of creating an informal consultation group for continuation of the discussion between sessions of the Working Group. It was explained that the informal consultation group would function by exchange of e-mails (and, as appropriate, meetings) and would be open to all interested delegations and observers. The Working Group welcomed the initiative. The hope was expressed that the operation of the informal consultation group would accommodate a degree of multilingualism. The Secretariat was requested to monitor the operation of the informal consultation group and to facilitate the presentation to the Working Group of proposals that interested Member States or observers might wish to make in respect of the draft instrument as a result of their informal consultations.

168. A number of delegations emphasized the importance of concluding work on the draft instrument within a reasonable time. Some delegations suggested 2005 or 2006 as reasonable targets. While no decision was made on a specific time frame, there was general agreement that, in continuation of the discussion at forthcoming sessions, the issue of overall timing should be constantly borne in mind and periodically reassessed by the Working Group.

**G. Note by the Secretariat on the preparation of a draft instrument  
on the carriage of goods [wholly or partly] [by sea], working paper submitted to  
the Working Group on Transport Law at its thirteenth session  
(A/CN.9/WG.III/WP.36) [Original: English]**

**Provisional redraft of the articles of the draft instrument considered in the  
Report of Working Group III on the work of its twelfth session (A/CN.9/544)**

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## **Introduction**

1. During its twelfth session, Working Group III considered a number of provisions of the draft instrument on the carriage of goods [wholly or partly][by sea] as contained in the annex to the note by the Secretariat (A/CN.9/WG.III/WP.32). The Secretariat was requested to prepare a revised draft of

those provisions considered, based on the deliberations and conclusions of the Working Group during its twelfth session as contained in the report of that session (A/CN.9/544). The provisional redraft of those articles appears in sections I to VII below.

## I. Title of the draft instrument

2. The title of the draft instrument was considered by the Working Group as reported at paragraphs 16 to 19 of A/CN.9/544. For the purposes of discussion, the title of the draft instrument will continue to be: “Draft instrument on the carriage of goods [wholly or partly][by sea]” until a decision is made in that respect by the Working Group.<sup>1</sup>

## II. Scope of application and performing parties

### A. Definition of “performing party” in article 1(e)

3. In addition to the definitions proposed in paragraph 4 below, the Working Group considered at paragraphs 34 to 42 of A/CN.9/544 the text of draft article 1(e) as it appeared in A/CN.9/WG.III/WP.32. While the exclusion of non-maritime performing parties from the draft instrument was discussed with approval by the Working Group at paragraphs 21 to 27 of A/CN.9/544, the definition of “performing party” was also considered as it appeared in A/CN.9/WG.III/WP.32, without the exclusion of non-maritime performing parties. Following the discussion of the Working Group at its twelfth session, the provisional revised version of draft article 1(e) would read as follows:

“(e) ‘Performing party’ means a person other than the carrier that physically performs or undertakes physically to perform<sup>2</sup> any of the carrier’s responsibilities under a contract of carriage, including<sup>3</sup> the carriage, handling, custody, or storage of the goods, to the extent that that person acts, either directly or indirectly, at the carrier’s request or under the carrier’s supervision or control.<sup>4</sup> The term ‘performing party’ does not include any person who is retained by a shipper or consignee, or is an employee, agent,<sup>5</sup> contractor, or

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<sup>1</sup> As noted at para. 19 of A/CN.9/544, the Working Group decided to retain the current title unchanged for the purposes of future discussion.

<sup>2</sup> As noted at para. 42 of A/CN.9/544, the Working Group made a provisional decision that the phrase “undertakes physically to perform” should be included in the definition without square brackets in order to both broaden the definition and clarify its limits in terms of physical performance pursuant to the contract of carriage.

<sup>3</sup> As further noted at para. 42 of A/CN.9/544, the Working Group asked the Secretariat to consider adding an inclusive phrase, such as “among others”, “inter alia” or a reference to “similar functions”, to the list of the carrier’s functions. The word “including” has been added here.

<sup>4</sup> In keeping with the Working Group’s request (see para. 42 of A/CN.9/544) to consider shortening the definition the phrase “regardless of whether that person is a party to, identified in, or has legal responsibility under the contract of carriage” has been deleted.

<sup>5</sup> As noted at para. 41 of A/CN.9/544, it was emphasized that the definition should not include an employee or agent as a performing party.

subcontractor of a person (other than the carrier) who is retained by a shipper or consignee.”<sup>6</sup>

## B. Definitions of “maritime performing party” and “non-maritime performing party”

4. The Working Group considered at paragraphs 28 to 33 of A/CN.9/544 proposals for the definition of maritime and non-maritime performing parties. Should the Working Group ultimately decide to remove “maritime performing parties” from the definition of “performing party” in draft article 1(e) as set out in paragraph 3 above, the definition would have to be slightly adjusted as noted below, and following the discussion of the Working Group at its twelfth session, the provisional revised version of proposed definitions of ‘maritime performing party’ and ‘non-maritime performing party’ would read as follows:<sup>7</sup>

“(e) ‘Performing party’ means a person other than the carrier that physically performs or undertakes physically to perform any of the carrier’s responsibilities under a contract of carriage, including the carriage, handling, custody, or storage of the goods, to the extent that that person acts, either directly or indirectly, at the carrier’s request or under the carrier’s supervision or control. The term ‘performing party’ includes maritime performing parties and non-maritime performing parties as defined in subparagraphs (f) and (g) of this paragraph but<sup>8</sup> does not include any person who is retained by a shipper or consignee, or is an employee, agent, contractor, or subcontractor of a person (other than the carrier) who is retained by a shipper or consignee.”

“(f) ‘Maritime performing party’ means a performing party who performs any of the carrier’s responsibilities during the period between the arrival of the goods at the port of loading [or, in case of trans-shipment, at the first port of loading] and their departure from the port of discharge [or final port of discharge as the case may be].<sup>9</sup> The performing parties that perform

<sup>6</sup> As noted at para. 41 of A/CN.9/544, if the Working Group decided to exclude non-maritime performing parties from the application of the draft instrument, language along the lines of the proposed definition in para. 4 below with respect to maritime and non-maritime performing parties would have to be included in this general definition in draft article 1(e).

<sup>7</sup> As noted at para. 31 of A/CN.9/544, there was general agreement in the Working Group that these definitions were a good basis for continuing the discussion on how to define maritime and non-maritime performing parties, and that a geographical approach to the definition was appropriate. It was also noted at the same paragraph that experience under national law in some States indicated that the application of the geographical approach (while generally appropriate), was likely to generate substantial litigation.

<sup>8</sup> The phrase “includes maritime performing parties and non-maritime performing parties as defined in subparas. (f) and (g) of this paragraph but” has been inserted into the general definition of “performing party” in order to allow for the exclusion of non-maritime performing parties. See note 6, *supra*.

<sup>9</sup> As noted at para. 31 of A/CN.9/544, there was support in the Working Group for the suggestion that inland movements within a port should be included in the definition of a maritime performing party, as, for example, in the case of a movement by truck from one dock to the next, but that a widely shared view was that movement between two physically distinct ports should be considered as part of a non-maritime performing party’s functions. This clarification could be achieved by the inclusion here of the phrase “including inland movements within a single port”.

any of the carrier's responsibilities inland during the period between the departure of the goods from a port and their arrival at another port of loading shall be deemed not to be maritime performing parties."

"(g) 'Non-maritime performing party' means a performing party who performs any of the carrier's responsibilities prior to the arrival of the goods at the port of loading or after the departure of the goods from the port of discharge."<sup>10</sup>

### III. Scope of application and localized or non-localized damage (draft article 18(2))

5. The text of draft article 18(2) was considered by the Working Group as reported at paragraphs 43 to 50 of A/CN.9/544. As noted at paragraph 50<sup>11</sup> of A/CN.9/544, the Working Group decided that it would be appropriate to maintain the draft article in square brackets pending the decision of the Working Group on the liability limit set forth in draft article 18(1). Therefore, the provisional text of draft article 18(2) would remain as follows:

"[2. Notwithstanding paragraph 1, if the carrier cannot establish whether the goods were lost or damaged during the sea carriage or during the carriage preceding or subsequent to the sea carriage, the highest limit of liability in the international and national mandatory provisions that govern the different parts of the transport shall apply.]"<sup>12</sup>

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It was further suggested at para. 31 of A/CN.9/544 that a rail carrier, even if it performed services within a port, should be deemed to be a non-maritime performing party. The Working Group may wish to consider this suggestion.

<sup>10</sup> A concern was raised at para. 33 of A/CN.9/544 regarding whether the definition should deal with performing parties in non-contracting States. It was suggested that this matter, if appropriate in light of concerns with respect to forum-shopping and the issue of enforcement of foreign judgements, could be dealt with later in view of the convention as a whole.

<sup>11</sup> The Working Group took note at para. 50 of A/CN.9/544 that opinions were fairly evenly divided between those who favoured the deletion of draft article 18(2) in its entirety, and those who favoured retaining it. Those in favour of deletion held that position firmly. However, some of those who favoured maintaining the provision for the moment did so with a number of nuances. The Working Group decided that it would be appropriate to maintain the draft article in square brackets pending the decision of the Working Group on the liability limit set forth in draft article 18(1).

<sup>12</sup> As noted at paras. 47 and 50 of A/CN.9/544, there was strong support for the deletion of draft article 18(2). Some of those who favoured maintaining the provision for the moment did so with a number of nuances. As noted at para. 46 of A/CN.9/544, it was suggested that as a matter of drafting, the phrase "international and national mandatory provisions" should be changed to "international or national mandatory provisions". A further refinement suggested was to keep draft article 18(2) in square brackets pending the insertion of liability limits in draft article 18(1), but to insert square brackets around the phrase "and national mandatory provisions" in order to mirror the current text in article 8. Another alternative suggested was that draft article 18(1) could establish the specific liability limit for localized damage, while draft article 18(2) could establish a second specific liability limit for non-localized damage without any reference to other liability limits in international and national mandatory provisions.

#### IV. Scope of application: definition of the contract of carriage and treatment of the maritime leg (draft articles 1(a) and 2)

6. The text of draft articles 1(a) and 2 was considered by the Working Group as reported at paragraphs 51 to 84 of A/CN.9/544. Following the discussion of the Working Group at its twelfth session, the provisional revised version of draft articles 1(a) and 2<sup>13</sup> would read as follows:

“Article 1. Definitions

“For the purpose of this instrument:

(a)<sup>14</sup> Contract of carriage means a contract under which a carrier against payment of freight undertakes to carry goods by sea from a place<sup>15</sup> in one State to a place in another State; such contract may also include an undertaking by such carrier to carry the goods by other modes prior to or after the carriage by sea.<sup>16</sup>

“Article 2. Scope of application

“1. Subject to paragraph 3, this instrument applies to all contracts of carriage if

(a) the place of receipt [or port of loading] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

(b) the place of delivery [or port of discharge] specified either in the contract of carriage or in the contract particulars is located in a Contracting State, or

<sup>13</sup> As noted at para. 67 of A/CN.9/544, the prevailing view in the Working Group was that Variants A, B and C of draft article 2(1) in A/CN.9/WG.III/WP.32 should be deleted from the future revised version of the draft instrument. In addition, as noted at para. 74 of A/CN.9/544, the Working Group decided that the “second proposal” for draft articles 1 and 2(1) should be kept for continuation of the discussion at a future session.

<sup>14</sup> As noted at para. 75 of A/CN.9/544, a further variant for draft article 1(a) could be:

“Contract of carriage means a contract under which a carrier against the payment of freight undertakes to carry goods from a place in one State to a place in another State if:

(i) the contract includes an undertaking to carry the goods by sea from a place in one State to a place in another State; or

(ii) the carrier may perform the contract at least in part by carrying the goods by sea from a place in one State to a place in another State, and the goods are in fact so carried.

In addition, a contract of carriage may also include an undertaking to carry goods by other modes prior to or after the international carriage by sea.”

<sup>15</sup> As noted at para. 69 of A/CN.9/544, in view of the difficulties anticipated in the definition of “port”, the prevailing view was that the more neutral word “place” could be used, in view of the focus on the sea carriage being expressed throughout the draft provision.

<sup>16</sup> As further noted at para. 69 of A/CN.9/544, and consistent with the last phrase of the variant suggested at para. 75 of A/CN.9/544 (also, see note 14, *supra*), it was suggested that the second phrase in subpara. (i) might read as follows: “In addition, such contract may also include an undertaking by such carrier to carry the goods by other modes prior to or after such international carriage by sea.”

(c) [the actual place of delivery is one of the optional places of delivery specified either in the contract of carriage or in the contract particulars and is located in a Contracting State, or]<sup>17</sup>

(d)<sup>18</sup> the contract of carriage provides that this instrument, or the law of any State giving effect to it, is to govern the contract.<sup>19</sup>

“[1bis. A contract that contains an option to carry the goods by sea shall be deemed to be a contract of carriage under article 1(a), provided that the goods are actually carried by sea.]”<sup>20</sup>

“2. This instrument applies without regard to the nationality of the ship, the carrier, the performing parties, the shipper, the consignee, or any other interested parties.”<sup>21</sup>

“3. This instrument does not apply to charter parties, [contracts of affreightment, volume contracts, or similar agreements].”<sup>22</sup>

<sup>17</sup> As noted at para. 59 of A/CN.9/544, the Working Group decided that the text should be maintained between square brackets for continuation of the discussion at a future session.

<sup>18</sup> As noted at para. 58 of A/CN.9/544, general support was expressed for the deletion of subparagraph (d) as it appeared in Variants A, B and C of draft article 2(1) of A/CN.9/WG.III/WP.32.

<sup>19</sup> The Working Group may wish to consider the suggestion (see para. 60 of A/CN.9/544) to replace at the beginning of the draft provision the words “the contract of carriage” with the words “the contract of carriage or any related contract” or the words “the contract of carriage or any contract related to the execution of the contract of carriage”.

<sup>20</sup> As noted at para. 74 of A/CN.9/544, the Working Group decided that the second proposal for draft articles 1(a) and 2(1) as reflected at para. 68 of A/CN.9/544 should be kept for continuation of the discussion at a future session, subject to the relocation of subpara. (ii) in square brackets outside of the definition of “contract of carriage” in draft article 1(a). This subpara. (ii) has now been relocated as para. 2(1bis). While divergent views were expressed on the issue of whether this subpara. should be deleted (see para. 72 of A/CN.9/544), or improved (see para. 71 of A/CN.9/544), the general view expressed at para. 73 of A/CN.9/544, was that while the text of this subpara. might need considerable redrafting, it was also felt that the draft instrument should provide for the situation where no specific mode of transport had been stipulated in the contract. The Working Group may wish to consider the approach taken in article 18(4) of the Montreal Convention, as suggested, the text of which is as follows: “The period of the carriage by air does not extend to any carriage by land, by sea or by inland waterway performed outside an airport. If, however, such carriage takes place in the performance of a contract of carriage by air, for the purpose of loading, delivery or transshipment, any damage is presumed, subject to proof to the contrary, to have been the result of an event which took place during the carriage by air. If a carrier, without the consent of the consignor, substitutes carriage by another mode of transport for the whole or part of a carriage intended by the agreement between the parties to be carriage by air, such carriage by another mode of transport is deemed to be within the period of carriage by air.”

<sup>21</sup> As noted at para. 76 of A/CN.9/544, the Working Group found the substance of para. (2) to be generally acceptable.

<sup>22</sup> While there was broad agreement in the Working Group (see para. 77 of A/CN.9/544) that certain types of contracts either should not be covered by the draft instrument at all, or should be covered on a non-mandatory, default basis, such as those contracts that, in practice, were the subject of extensive negotiation between shippers and carriers, there were diverging views on the best legislative technique to be used in excluding those contracts that should not be covered on a mandatory basis (see para. 78 of A/CN.9/544). One suggestion was that such contracts should not be dealt with in draft article 2 but rather in chapter 19 dealing with freedom of contract, with the possible addition of a reference to “ocean liner service agreements (OLSAs)”

“4. Notwithstanding paragraph 3, if a negotiable transport document or a negotiable electronic record is issued pursuant to a charter party, [contract of affreightment, volume contract, or similar agreement], then the provisions of this instrument apply to the contract evidenced by or contained in that document or that electronic record from the time when and to the extent that the document or the electronic record governs the relations between the carrier and a holder other than the charterer.”<sup>23</sup>

“5. If a contract provides for the future carriage of goods in a series of shipments, this instrument applies to each shipment to the extent that paragraphs 1, 2, 3 and 4 so specify.”<sup>24</sup>

## V. Exemptions from liability, navigational fault, and burdens of proof (draft article 14)

### A. Draft article 14

7. The text of draft article 14 was considered by the Working Group as reported at paragraphs 85 to 144 of A/CN.9/544. Following the discussion of the Working Group at its twelfth session, the provisional revised version of draft article 14 would read as follows:<sup>25</sup>

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as described in document A/CN.9/WG.III/WP.34, a proposed definition for which was set out at para. 78 of A/CN.9/544. Another view was that para. (3) should be deleted and that the issue should be dealt with in the provisions of the draft instrument on freedom of contract (see para. 79 of A/CN.9/544), while another view was that instead of defining types of contracts to be excluded from the application of the draft instrument, it might be easier to define situations where it would be inappropriate for the draft instrument to apply mandatorily (see para. 80 of A/CN.9/544). While the Secretariat was requested to prepare a revised draft of this provision, with possible variants, the Working Group may wish to engage in further discussion and clarification of this issue, for example, with respect to whether the scope of application should be decided on the basis of the types of transport documents to be included in the mandatory regime, or whether inclusion should be based on the contract of carriage, or on the basis of the type of trade intended to be included in the mandatory regime.

<sup>23</sup> As noted at para. 83 of A/CN.9/544, subject to possible reconsideration of the placement of para. (4) after the discussion of chapter 19, the Working Group found the substance of the draft provision to be generally acceptable. It was decided that the words “[contract of affreightment, volume contract, or similar agreement]” should be retained in square brackets for further discussion.

<sup>24</sup> As noted at para. 84 of A/CN.9/544, subject to possible reconsideration of the placement of para. (4) after discussion of chapter 19, the Working Group found the substance of the draft provision to be generally acceptable. Further, if para. (1 bis) is maintained in this draft article, reference to it should also be included with the references to the other paras. in the final phrase of this para.

<sup>25</sup> As noted at para. 110 of A/CN.9/544, unanimous support was expressed that the third redraft (in respect of subparas. (2) and (4); see para. 108 of A/CN.9/544) and the second redraft (in respect of the remainder of draft article 14, see para. 101 of A/CN.9/544) should form the basis for future work on draft article 14(2); subject to those additional drafting suggestions indicated at paras. 85 to 144.



“Article 14. Basis of liability

“1. The carrier shall be liable for loss resulting from loss of or damage to the goods, as well as from delay in delivery, if the [claimant]<sup>26</sup> proves that

(a) The loss, damage, or delay; or

(b) The occurrence that caused [or contributed to] the loss, damage, or delay

took place during the period of the carrier's responsibility as defined in chapter 3, unless [and to the extent] the carrier proves that neither its fault nor the fault of any person mentioned in article 14 bis<sup>27</sup> caused [or contributed to] the loss, damage or delay.

“2.<sup>28</sup> Without prejudice to paragraph 3,<sup>29</sup> if [and to the extent]<sup>30</sup> the carrier, alternatively to proving the absence of fault as provided in paragraph 1<sup>31</sup> proves that the loss, damage or delay was caused by one of the following events:

..... [insert the “excepted perils”, see section B below]

Then the carrier shall be liable for such loss, damage or delay<sup>32</sup> if [and to the extent]<sup>33</sup> the claimant proves that:

(i) The fault of the carrier or of a person mentioned in article 14 bis caused [or contributed to] the event on which the carrier relies under this paragraph; or

(ii) An event other than those listed in this paragraph<sup>34</sup> contributed to the loss, damage or delay. In this case, liability is to be determined<sup>35</sup> in accordance with paragraph 1.<sup>36</sup>

<sup>26</sup> As suggested at paras. 105 and 133 of A/CN.9/544, the word “shipper” has been replaced with the word “claimant”, however the Working Group may wish to consider whether a definition of “claimant” should be included in draft article 63 of the draft instrument when it discusses that provision.

<sup>27</sup> This is a reference to draft article 15(3) in A/CN.9/WG.III/WP.32, which the Working Group agreed should become a separate article provisionally numbered 14 bis. See paragraph 167 of A/CN.9/544 and the discussion of draft article 15(3) summarized at paragraphs 166-170.

<sup>28</sup> As noted at para. 115 of A/CN.9/544, with the various changes made to this provision, the counterproof provisions in subparagraphs (i) and (ii) of para. (2) might have become unclear, and the suggestion was made to separate paragraph 2 into two separate sentences in order to clarify this potential problem. The Working Group may wish to consider this suggested clarification.

<sup>29</sup> The phrase “Without prejudice to paragraph 3” was added in order to clarify the relationship between paras. (2) and (3) as agreed by the Working Group at para. 112 of A/CN.9/544.

<sup>30</sup> The phrase “[and to the extent]” was added as agreed by the Working Group at para. 112 of A/CN.9/544.

<sup>31</sup> The square brackets around the phrase “, alternatively to proving the absence of fault as provided in paragraph 1” were removed as agreed by the Working Group at para. 113 of A/CN.9/544.

<sup>32</sup> As noted at para. 113 of A/CN.9/544, the following alternative language was suggested for the phrase “then its liability ... will arise”: “then the carrier’s liability is maintained or continued”, or “then the carrier shall be liable for such loss, damage or delay”.

<sup>33</sup> The phrase “only in the event” was deleted, and the phrase “if [and to the extent]” was substituted as agreed by the Working Group at para. 112 of A/CN.9/544.

“3. To the extent that the [claimant]<sup>37</sup> proves [that there was] [that the loss, damage, or delay was caused by] [that the loss, damage, or delay could have been caused by],<sup>38</sup>

- (i) The unseaworthiness of the ship;
- (ii) The improper manning, equipping, and supplying of the ship; or
- (iii) The fact that the holds or other parts of the ship in which the goods are carried (including containers, when supplied by the carrier, in or upon which the goods are carried) were not fit and safe for the reception, carriage, and preservation of the goods,

then the carrier shall be<sup>39</sup> liable under paragraph 1 unless it proves that,

(a) It complied with its obligation to exercise due diligence as required under article 13(1). [; or

(b) The loss, damage or delay was not caused by any of the circumstances<sup>40</sup> mentioned in (i), (ii) and (iii) above.]<sup>41</sup>

“4. In case the fault of the carrier or of a person mentioned in article 14 bis has contributed to the loss, damage or delay together with concurring causes for which the carrier shall not be liable, the amount for which the carrier shall

<sup>34</sup> As noted at para. 111 of A/CN.9/544, it was suggested that a remedy for the inadvertent result that the text of subpara. 2(ii) could suggest that it was necessary for the shipper or claimant to prove both the additional cause for the loss and that it was outside the list of “excepted perils” in subpara. 2(i) would be to insert in subpara. 2(ii) after the phrase “an event other than those listed in this paragraph”, the additional phrase “on which the carrier relies”. The Working Group may wish to consider the addition of this phrase.

<sup>35</sup> For greater certainty, the word “assessed” has been changed to “determined”.

<sup>36</sup> As noted at para. 114 of A/CN.9/544, in order to express the general agreement that where the shipper or claimant proved a cause for the damage attributable to the carrier but outside the list of “excepted perils” under subpara. (ii), resort should be had back to para. 1, the following sentence was added to the end of subpara. (ii): “In this case, liability is to be assessed in accordance with paragraph 1.”

<sup>37</sup> See note 26, *supra*.

<sup>38</sup> As noted at para. 132 of A/CN.9/544, the Working Group was of the view that the text should remain with its two alternative approaches for further consideration and consultation prior to making a decision on this matter. It was also suggested that the notion of “likelihood of causation” by one of the events in subparas. (i), (ii) or (iii) might need to be further explored, and that wording along the lines of “[that the loss, damage, or delay could have been caused by]” could be a possible formulation for the third alternative.

<sup>39</sup> As noted at para. 103 of A/CN.9/544, one drafting observation made with respect to the redrafted article as a whole was that the phrase “shall be liable” and “is liable” were both used, and that consistency should be sought in this regard.

<sup>40</sup> In an effort to achieve greater clarity, it is suggested that this word could be changed from “facts” to the more inclusive “circumstances”, or, alternatively, to “occurrences” or “matters”.

<sup>41</sup> The Working Group may also wish to consider the alternative structuring for para. (3) of which it took note as follows at para. 134 of A/CN.9/544 :

“3. The carrier is not liable for loss, damage, or delay resulting from the unseaworthiness of the ship as [alleged] [proved] by the claimant, to the extent that the carrier proves that

“(a) It complied with its obligation to exercise due diligence as required under article 13(1). [; or

“(b) The loss, damage or delay was not caused by any of the facts mentioned in (i), (ii) and (iii) above.]”.

be liable, without prejudice to its right to limit liability as provided by article 18, shall be determined [by the court] in proportion to the extent to which the loss, damage or delay is attributable to its fault. [The court may only apportion liability on an equal basis if it is unable to determine the actual apportionment or if it determines that the actual apportionment is on an equal basis.]”<sup>42</sup>

## B. The “excepted perils”

8. The text of the “excepted perils” in draft article 14 of A/CN.9/WG.III/WP.32 was considered by the Working Group as reported at paragraphs 117 to 129 of A/CN.9/544. Following the discussion of the Working Group at its twelfth session, the provisional revised version of the list of “excepted perils” in draft article 14 would read as follows:

“(a) [Act of God],<sup>43</sup> war, hostilities, armed conflict, piracy, terrorism,<sup>44</sup> riots and civil commotions;<sup>45</sup>

“(b) Quarantine restrictions; interference by or impediments created by governments, public authorities, rulers<sup>46</sup> or people [including interference by or pursuant to legal process];<sup>47</sup>

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<sup>42</sup> As noted at para. 143 of A/CN.9/544, a widely accepted proposal was to add in square brackets the last sentence proposed in the second redraft along the lines of “[The court may only apportion liability on an equal basis if it is unable to determine the actual apportionment or if it determines that the actual apportionment is on an equal basis.]” It was widely felt that further discussion could be based on that text. The Working Group may also wish to consider further an alternative proposal of which it took note, which was intended to take into account the situation addressed in subpara. 2(ii) where the damage was not caused by actual fault, as follows:

“4. In case the fault of the carrier or of a person mentioned in article 14bis [or an event other than the one on which the carrier relied] has contributed to the loss, damage or delay together with concurring causes for which the carrier is not liable, the amount for which the carrier is liable, without prejudice to its right to limit liability as provided by article 18, shall be determined [by the court] in proportion to the extent to which the loss, damage or delay is attributable to such fault [or event].”

<sup>43</sup> As noted at para. 120 of A/CN.9/544, there was broad support in the Working Group for the proposal that the “act of God” exception should be maintained.

<sup>44</sup> As noted at para. 121 of A/CN.9/544, the general view in the Working Group was that piracy and terrorism should be included in the list.

<sup>45</sup> As noted at para. 125 of A/CN.9/544, it was suggested that subparas. (a) and (b) should be broadened by adding the phrase “and all other events that are not the fault of the carrier”. The Working Group may wish to consider this suggestion.

<sup>46</sup> As noted at para. 125 of A/CN.9/544, the word “rulers” was questioned as meaningless in light of modern political realities. The Working Group may wish to consider this in future discussions.

<sup>47</sup> As noted at para. 122 of A/CN.9/544, there was support for the suggestion that the square brackets be removed and the text be maintained, but the question was raised whether the phrase “including interference by or pursuant to legal process” could also include the situation where a cargo claimant arrested a ship. The suggestion was made to clarify the meaning of that phrase. The suggested clarification could be achieved by returning to the language of article IV.2.g of the Hague and Hague-Visby Rules, where “seizure under legal process” clearly excluded the arrest of a ship. See, also, the suggestion in footnote 45, *supra*.

“(c) Act or omission of the shipper, the controlling party or the consignee;

“(d) Strikes, lockouts, stoppages or restraints of labour;<sup>48</sup>

“(e) Wastage in bulk or weight or any other loss or damage arising from inherent quality, defect, or vice of the goods;

“(f) Insufficiency or defective condition of packing or marking;<sup>49</sup>

“(g) Latent defects in the ship<sup>50</sup> not discoverable by due diligence;<sup>51</sup>

“(h) Handling, loading, stowage or unloading of the goods by or on behalf of the shipper,<sup>52</sup> the controlling party or the consignee;

“(i) Acts of the carrier or a performing party in pursuance of the powers conferred by articles 12 and 13(2) when the goods have become a danger to persons, property or the environment or have been sacrificed;

“(j) Any other cause arising without the actual fault or privity of the carrier, or without the actual fault or neglect of the agents or servants of the carrier, but the burden of proof shall be on the person claiming the benefit of this exception to show that neither the actual fault or privity of the carrier nor the fault or neglect of the agents or servants of the carrier contributed to the loss or damage.”<sup>53</sup>

9. As noted at paragraph 117 of A/CN.9/544, support was expressed in the Working Group that the two exceptions to the general approach of including the list of perils from article IV.2.c through article IV.2.q of the Hague and Hague-Visby Rules were the deletion of article IV.2.a (error in navigation), and the redrafting of article IV.2.b (fire exception) to reflect its limited application to the maritime leg of the transport. As noted at paragraph 128 of A/CN.9/544, the Working Group agreed to leave the fire exception and the currently-deleted exception for error in navigation in chapter 6, draft article 22 of the draft instrument

<sup>48</sup> As noted at para. 123 of A/CN.9/544, the Working Group noted the suggestion that the subparagraph might need to establish a distinction between general strikes and strikes that might occur in the carrier's business, and for which the carrier might bear some fault. Further, as noted at para. 125 of A/CN.9/544, uncertainty was expressed with respect to the precise meaning of the phrase “restraints of labour”. The Working Group may wish to consider further these issues.

<sup>49</sup> As noted at para. 125 of A/CN.9/544, it was proposed that it be clarified that the packing or marking should have been done “by the shipper”. Again, the Working Group may wish to consider further this suggestion.

<sup>50</sup> As noted at para. 125 of A/CN.9/544, there was support for the view that this subparagraph should make it clear that the latent defects referred to were those in the ship.

<sup>51</sup> As noted at para. 125 of A/CN.9/544, it was noted that if the phrase “due diligence” was used elsewhere, for example in draft article 13, it should also be repeated here in the interest of consistency.

<sup>52</sup> As noted at para. 125 of A/CN.9/544, it was suggested that the phrase “or on behalf of the shipper” in this subparagraph should be deleted as confusing. The Working Group may wish to consider further this suggestion.

<sup>53</sup> This is the text of article IV.2.q of the Hague and Hague-Visby Rules, inserted for future discussion of the text. As noted at paras. 117 and 129 of A/CN.9/544, the Working Group agreed that the list of “excepted perils” should be included in the draft instrument, and that the substance and content of the exceptions on the list should be inspired from the Hague and Hague-Visby Rules, including article IV.2.q.

(A/CN.9/WG.III/WP.32) and separate from the list of “excepted perils” in draft article 14, for future consideration of where best to place them in the draft instrument. The text of the fire exception in both variants A and B of draft article 22 will remain as it currently exists:

“Article 22. Liability of the carrier

[...]

“fire on the ship, unless caused by the fault or privity of the carrier.”<sup>54</sup>

10. As noted at paragraph 127 of A/CN.9/544, the prevailing view in the Working Group was that the deletion of the navigational error exception should be maintained, but also that the impact of that decision should be considered with respect to the allocation of burdens of proof in discussions to come.

## VI. Obligations of the carrier in respect of the voyage by sea (draft article 13)

11. The text of draft article 13 was considered by the Working Group as reported at paragraphs 145 to 157 of A/CN.9/544. Following the discussion of the Working Group at its twelfth session, the provisional revised version of draft article 13 would read as follows:

“Article 13. Additional obligations applicable to the voyage by sea

“1. The carrier shall be bound, before, at the beginning of, and during<sup>55</sup> the voyage by sea, to exercise due diligence to:

“(a) Make and keep the ship seaworthy;

“(b) Properly man,<sup>56</sup> equip and supply the ship and keep the ship so manned,<sup>57</sup> equipped and supplied throughout the voyage;<sup>58</sup>

<sup>54</sup> As noted at para. 126 of A/CN.9/544, while it was agreed that the fire exception should be maintained, diverging views were expressed in the Working Group with respect to the text of the exception, and its text is thus reproduced without change.

<sup>55</sup> As noted at para. 153 of A/CN.9/544, the Working Group agreed that the carrier’s obligation of due diligence in respect of seaworthiness should be a continuing one, and that all square brackets in draft article 13(1) surrounding the phrases “and during” in draft article 13(1), “and keep” in draft article 13(1)(a), and “and keep” in draft article 13(1)(c) should thus be removed, and the text in them retained. The Working Group also agreed that making this obligation a continuing one affected the balance of risk between the carrier and cargo interests in the draft instrument, and that care should be taken by the Working Group to bear this in mind in its consideration of the rest of the instrument.

<sup>56</sup> As noted at para. 148 of A/CN.9/544, a drafting suggestion made was that gender-neutral language such as “crew” or “staff” could be considered instead of the phrase “man ... the ship”. The Working Group may wish to consider this suggestion.

<sup>57</sup> *Ibid.*

<sup>58</sup> As noted at para. 153 of A/CN.9/544, the Working Group requested the Secretariat to make the necessary changes to subpara. (b) to ensure that this obligation was understood to be of a continuing nature. It is suggested that the addition of the phrase “throughout the voyage” could achieve this effect. A possible alternative could be to insert the phrase “and continuously” after the opening word, “Properly”.

“(c) Make and keep the holds and all other parts of the ship in which the goods are carried, including containers where supplied by the carrier, in or upon which the goods are carried fit and safe for their reception, carriage and preservation.

“[2. Notwithstanding articles 10, 11, and 13(1), the carrier may sacrifice goods when the sacrifice is reasonably made for the common safety or for the purpose of preserving from peril<sup>59</sup> human life or<sup>60</sup> other property involved in the common adventure.]”<sup>61</sup>

## VII. Liability of performing parties (draft article 15)

12. The text of draft article 15 was considered by the Working Group as reported at paragraphs 158 to 181 of A/CN.9/544. Following the discussion of the Working Group at its twelfth session, the provisional revised version of draft articles 14 bis and 15 would read as follows:

“Article 14 bis.<sup>62</sup>

“Subject to paragraph 15(4),<sup>63</sup> the carrier shall be responsible for the acts and omissions of

(a) any performing party, and

(b) any other person, including a performing party’s subcontractors, employees<sup>64</sup> and agents, who performs or undertakes to perform any of the carrier’s responsibilities under the contract of carriage, to the extent that the person acts, either directly or indirectly, at the carrier’s request or under the

<sup>59</sup> As noted at paras. 156 and 157 of A/CN.9/544, the Working Group requested the Secretariat to consider the drafting suggestion to include a reference to the presence of imminent danger, but that care should be taken not to prejudice or alter the rules on general average. Consistent with the language in Rule A of the York-Antwerp Rules of 1994, the phrase “from peril” was added after the word “preserving”.

<sup>60</sup> As noted at para. 157 of A/CN.9/544, the Working Group requested the Secretariat to consider the drafting suggestion to include a reference to the preservation of human life. The phrase “human life” has been added before the phrase “or other property”.

<sup>61</sup> As noted at para. 157 of A/CN.9/544, the Working Group decided to maintain draft article 13(2) in square brackets in its current location, with a view to considering at a later stage whether it should be moved to chapter 17 on general average.

<sup>62</sup> Formerly draft article 15(3), but moved and provisionally numbered “article 14 bis” on the agreement of the Working Group as noted at para. 167 of A/CN.9/544.

<sup>63</sup> As noted at para. 170 of A/CN.9/544, the Working Group decided to maintain this opening phrase, although the suggestion was made that it should be replaced with the phrase “Subject to the liability and limitations of liability available to the carrier” since draft article 14 bis (formerly draft article 15(3)) dealt with actions brought against the carrier, while draft article 15(4) (formerly draft article 15(5)) dealt with actions brought against any person other than the carrier.

<sup>64</sup> As noted at para. 168 of A/CN.9/544, the Working Group agreed to the addition of the word “employees” so that draft article 14 bis would mirror the language in draft article 15(3) (formerly draft article 15(4)). As further noted at para. 168, as a matter of drafting, further consideration might need to be given to the possibility of dealing separately with employees (for whom the contracting carrier’s liability should be very broad) and with subcontractors (in respect of whom the liability of the contracting carrier might be somewhat narrower).

carrier's supervision or control, as if such acts or omissions were its own. The carrier is responsible under this provision only when the performing party's or other person's act or omission is within the scope of its contract, employment, or agency.

“Article 15. Liability of maritime<sup>65</sup> performing parties

“1.<sup>66</sup> A maritime<sup>67</sup> performing party is subject to the responsibilities and liabilities imposed on the carrier under this instrument, and entitled to the carrier's rights and immunities provided by this instrument if the occurrence that caused the loss, damage or delay took place<sup>68</sup> (a) during the period in which it has custody of the goods; and (b) at any other time to the extent that it is participating in the performance of any of the activities contemplated by the contract of carriage.

“2. If the carrier agrees to assume responsibilities other than those imposed on the carrier under this instrument, or agrees that its liability for the delay in delivery of, loss of, or damage to or in connection with the goods shall be higher than the limits imposed under articles 16(2), 24(4) and 18,<sup>69</sup> a maritime<sup>70</sup> performing party shall not be bound by this agreement unless the maritime<sup>71</sup> performing party expressly agrees to accept such responsibilities or such limits.

“3.<sup>72</sup> Subject to paragraph 4,<sup>73</sup> a performing party shall be responsible for the acts and omissions of any person to whom it has delegated the performance of any of the carrier's responsibilities under the contract of carriage, including its subcontractors, employees, and agents, as if such acts or omissions were its own. A performing party is responsible under this provision only when the act

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<sup>65</sup> As noted at para. 159 of A/CN.9/544, the word “maritime” has been inserted in accordance with the decision of the Working Group that the title of the draft article should be adjusted to reflect its agreement to limit the scope of draft article 15 to “maritime performing parties” as discussed at paras. 23 to 33 of A/CN.9/544.

<sup>66</sup> Draft article 15(1) uses Variant A (from A/CN.9/WG.III/WP.32) as its basis, given the broad support for Variant A as noted at para. 162 of A/CN.9/544.

<sup>67</sup> As noted at para. 161 of A/CN.9/544, the Working Group reaffirmed its understanding that the draft instrument should, in principle, avoid dealing with non-maritime performing parties and that the scope of para. (1) should be restricted to maritime performing parties. The word “maritime” has been added to reflect that understanding.

<sup>68</sup> As noted at para. 162 of A/CN.9/544, the Working Group agreed to insert the words: “if the occurrence that caused the loss, damage or delay took place” before the text of subpara. (a).

<sup>69</sup> As noted at para. 165 of A/CN.9/544, the Working Group took note of the suggestion to limit the reference to draft article 18, since it was stated that, while the reference to paras. (1), (3) and (4) of draft article 18 was acceptable, para. (2) of draft article 18 should not be referred to since the performing party was not liable in case of non-localized damage. The Working Group decided that this suggestion might need to be further discussed after a decision had been made regarding the inclusion of para. (2) of draft article 18 in the draft instrument.

<sup>70</sup> As noted at para. 163 of A/CN.9/544, the Working Group agreed that the scope of para. (2) should be restricted to maritime performing parties.

<sup>71</sup> *Ibid.*

<sup>72</sup> This provision, formerly para. (4), was renumbered to account for the separation of draft article 15(3) into the new draft article 14 bis.

<sup>73</sup> This provision, formerly para. (5), was renumbered to account for the separation of draft article 15(3) into the new draft article 14 bis.

or omission of the person concerned is within the scope of its contract, employment, or agency.<sup>74</sup>

“4.<sup>75</sup> If an action under this instrument<sup>76</sup> is brought against any person,<sup>77</sup> other than the carrier, mentioned in article 14 bis<sup>78</sup> and paragraph 3,<sup>79</sup> [including employees or agents of the contracting carrier or of a maritime performing party,]<sup>80</sup> that person is entitled to the benefit of the defences and limitations of liability available to the carrier under this instrument if it proves that it acted within the scope of its contract, employment, or agency.

“5.<sup>81</sup> If more than one maritime performing party<sup>82</sup> is liable for the loss of, damage to, or delay in delivery of the goods, their liability is joint and several but only up to the limits provided for in articles 16, 24 and 18.

“6.<sup>83</sup> Without prejudice to article 19, the aggregate liability of all such persons shall not exceed the overall limits of liability under this instrument.”<sup>84</sup>

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<sup>74</sup> As noted at para. 172 of A/CN.9/544, the Working Group reaffirmed its decision that the structure of this para. should mirror new draft article 14 bis, and took note of the views expressed regarding whether draft article 15(3) (formerly 15(4)) should cover both maritime and non-maritime performing parties for continuation of the discussion at a future session.

<sup>75</sup> This provision, formerly para. (5), was renumbered to account for the separation of draft article 15(3) into the new draft article 14 bis.

<sup>76</sup> As noted at para. 176 of A/CN.9/544, it was suggested that the phrase “under this instrument” should be added after the phrase “an action” to clarify it.

<sup>77</sup> As noted at para. 175 of A/CN.9/544, the Secretariat was requested to examine the possibility of introducing a further variant limiting the scope of this para. to the maritime sphere. It is suggested that this could be accomplished by substituting the words “maritime performing party” for the word “person”, as was done in para. (5) (formerly para. (6)).

<sup>78</sup> This provision, formerly draft article 15(3), was renumbered to account for the separation of draft article 15(3) into the new draft article 14 bis.

<sup>79</sup> This provision, formerly para. (4), was renumbered to account for the separation of draft article 15(3) into the new draft article 14 bis.

<sup>80</sup> As noted at para. 175 of A/CN.9/544, the Working Group agreed that, as an alternative to the existing text of para. (4) (formerly para. (5)), the words “employees or agents of the contracting carrier or of a maritime performing party” should be inserted in square brackets for continuation of the discussion at a future session. The Working Group may wish to consider the following simplified text for the opening phrase of the paragraph ending with “that person”: “If an action under this instrument is brought against any maritime performing party [including its sub-contractors, employees or agents,] that person ...”.

<sup>81</sup> This provision, formerly para. (6), was renumbered to account for the separation of draft article 15(3) into the new draft article 14 bis.

<sup>82</sup> As noted at para. 180 of A/CN.9/544, the Working Group agreed that the scope of this paragraph should be limited to maritime performing parties, thus the phrase “maritime performing party” has been substituted for the word “person”. It was suggested that a proposal to simplify the text of this paragraph along the following lines: “The contracting carrier and the maritime performing party are jointly and severally liable” should be further discussed in the context of para. (6) (formerly para. (7)).

<sup>83</sup> This provision, formerly para. (7), was renumbered to account for the separation of draft article 15(3) into the new draft article 14 bis.

<sup>84</sup> As noted at para. 181 of A/CN.9/544, due to the absence of sufficient time, the Working Group did not discuss this paragraph.



**H. Working paper on the preparation of a draft instrument on the carriage of goods [wholly or partly] [by sea]: proposal by China, submitted to the Working Group on Transport Law at its thirteenth session (A/CN.9/WG.III/WP.37) [Original: Chinese and English]**

In preparation for the thirteenth session of Working Group III (Transport Law), during which the Working Group was expected to proceed with its reading of the draft instrument contained in document A/CN.9/WG.III/WP.32, the Government of China, on 29 April 2004, submitted the text of a proposal concerning Chapter 19 of the draft instrument and the issue of freedom of contract. The text of that proposal is reproduced as an annex to this note in the form in which it was received by the Secretariat.

**Annex. Proposal by China on Chapter 19 of the Draft Instrument and the Issue of Freedom of Contract**

By Chinese delegation ( 2004.4.26 New York )

**I. Background**

1. With the development of shipping industry, the mandatory regimes adopted by the Hague Rules are somewhat out of date, and the Hamburg Rules are not advisable either.
2. In practice merchants seldom conclude an agreement in writing in liner service and the contract of carriage is often evidenced only by bill of lading, sea waybill or other transport documents issued by the carrier after he receives the goods. As a transport document is made and issued by the carrier unilaterally, and it belongs to the contract of adhesion, it is advisable that the transport law should limit the freedom of contract in this respect.
3. However, it is improper that the transport law limits the freedom of contract in respect of all types of contract concluded in a liner service. It is the fact that the cargo interests or the parties on behalf of them are able to negotiate with carriers on the basis of equality under many circumstances in the liner trade nowadays, for example contracts of affreightment or ocean liner service agreements (OLSAs). Therefore, under these circumstances, the maritime law shouldn't continue to deny the principle of contract freedom. We have noticed the suggestion regarding OLSAs put forward by the United States. But we don't think OLSAs can include all types of contracts freely negotiated in liner service, and there are many problems in respect of the definition of OLSAs.
4. In addition, the voyage charter party belongs to the contract of carriage of goods by sea in nature. And it should be noted that the Hague rules or the Hague-visby rules are often incorporated into the charter parties by special agreement (such as a paramount clause) nowadays. So we think it logical that this Instrument extends to govern the voyage

charter parties. And this will contribute to greater uniformity of laws on carriage of goods by sea notwithstanding it should be created on a non-mandatory basis. We can also find the same principle in Chinese Maritime Code (CMC), Chapter IV of which is entitled “contract of carriage of goods by sea” and governs not only bills of lading but also voyage charter parties. The provisions thereof is mandatory in respect of bills of lading or other transport documents, and non-mandatory in respect of the voyage charter parties except for the obligation of seaworthiness and the obligation not to deviate. The ten-year practice of CMC has proved that the regime is advisable.

5. Therefore, the chief revision to the Instrument in our proposal suggests that the application of the Draft Instrument should be considered respectively under two different circumstances. The provisions of the Instrument should be deemed as mandatory while being based on the concept of “transport document”(including the electronic record). On the other hand, the provisions should be non-mandatory as default rules in respect of the newly coined notion “agreement concluded through free negotiation”, which may include voyage charter parties, contracts of affreightment, volume contracts, OLSAs and other similar contracts.

[6. We believe it is the best choice that this Instrument extends to govern the voyage charter parties or similar agreements. However, if this viewpoint would not be widely accepted, we consider that this Instrument should provide in Article 2 (“Scope of application”): This Instrument applies only to (i) a transport document; or(ii) an electronic record; or (iii) any contract of carriage concluded in a Liner Service. Then “ agreement concluded through free negotiation” in Article B of our proposal will only mean one concluded in a Liner Service.]

## II. Recommendation and Brief Explanation

### Article A

**A.1. Unless otherwise specified in this instrument, any provision in a transport document or an electronic record shall be null and void if:**

- (a) **it directly or indirectly lessens or relieves from the liabilities that the carrier or the maritime performing party assumes under this Instrument; or**
- (b) **it directly or indirectly increases the liabilities that the cargo interests assume under this Instrument; or**
- (c) **it assigns the benefit of insurance of the goods in favour of the carrier or a performing party.**

**A.2 The cargo interests referred to in the preceding paragraph include the shipper, the consignor, the controlling party, the holder of a transport document and the consignee.**

7. This article provides the mandatory scope of application of the Instrument, i.e. it is limited to “transport document”(including electronic record) which is a basic concept of the Instrument. The notion of “transport document” includes bills of lading, sea waybills, etc. It is a document issued by the carrier at the time that he receives the goods and evidencing the contract of carriage.

8. The original text of article 88.2 of this Instrument is: Notwithstanding paragraph 1, the carrier or a performing party may increase its responsibilities and obligations under this instrument. Our proposal has made this provision superfluous. Therefore, it has been deleted.

9. The original article 89(a) of this Instrument should also be deleted. It would be very detrimental to the cargo interests if carriers may enjoy such exonerations regarding live animals through provisions in a transport document. The Hamburg rules also apply to live animals, but contain a special provision excluding the carrier's liability where loss, damage or delay is due to special risks inherent in that kind of carriage (Art.5.5). And the Hamburg rules don't permit contractual freedom such as this Instrument. We think Article 5.5 of the Hamburg rules is more advisable in this respect. Therefore, besides deleting Article 89(a), this Instrument should also introduce similar provisions based on article 5.5 of the Hamburg rules.

10. The original article 89(b) of this Instrument deals with "special cargo" not carried in the ordinary course of trade. Our position is that this provision should be deleted. It is noticed that article 89(b) adopts the same principle as the Hague rules. It should be further considered whether it is appropriate now. We consider that this Instrument may introduce specific provisions dealing with such "special cargo" in other Chapter of it.

#### **Article B**

**B.1. Subject to Article C, when an agreement regarding the carriage of goods is concluded through free negotiation, provisions in this Instrument shall apply only in the absence of relevant provisions or in the absence of provisions differing therefrom in the agreement. But provisions in this agreement have no legal binding force on a third party.**

**B.2. The agreement referred to in the preceding paragraph shall be made in written form other than transport documents. Telegrams, telexes, telefaxes, electronic data interchange and e-mails have the effect of something in writing.**

**B.3. [Any valid agreement in writing (other than a transport document) regarding the carriage of goods is presumed to be an agreement concluded through free negotiation. But the cargo interests mentioned in Article A is entitled to prove that it is an agreement that is formulated in anticipation by the carrier and its provisions are not permitted to alter through negotiation in the making of it. ]**

**B.4. [If any agreement regarding the carriage of goods doesn't conform to the requirements mentioned in the paragraph 1 and paragraph 2 of this article, the circumstances specified in Article A which make the provisions null and void shall also apply to this agreement.]**

11. This article is intended to deal with voyage charter parties, contracts of affreightment, volume contracts, OLSAs and other agreements freely negotiated. As this article has expanded the scope of application of this Instrument, Articles 2.3, 2.4 and 2.5 of this Instrument should be deleted.

12. The purpose of using the phrase "concluded through free negotiation" is to emphasize that the agreement referred to in this article is not a contract of adhesion. This phrase clearly means the essential characteristics of this kind of contract, i.e. it is a contract freely

and equally negotiated. According to the principle of freedom of contract, the Instrument shall not apply forcibly but as a default rule.

13. From viewpoint of the legislative technique, the phrase “agreement concluded through free negotiation” can avoid the need of defining voyage charter parties, volume contracts, contracts of affreightment, OLSAs and similar contracts and overcome the problem of identifying these contracts. We think that it is very difficult or nearly impossible to exactly define these kinds of contracts. The names about these contracts are used confusedly, and there are controversies in respect whether they belong to contracts of carriage or charter parties. Furthermore, new kinds of contracts may appear in the future when commercial practices change rapidly.

14. The paragraph 3 of this article is intended to provide protections to the cargo interests under some circumstances, especially in respect of some small cargo-owners.

### Article C

**Any provision directly or indirectly lessening or relieving from the liabilities of the carrier or the maritime performing party in the agreement concluded through free negotiation mentioned in Article B shall be null and void, if such liabilities result from:**

- (a) **the violation of the obligation as required under Article 13.1; or**
- (b) **the deviation;[ or**
- (c) **an act or omission of the carrier or the performing party done with the intent to cause the loss, damage or delay in delivery of the goods or recklessly and with knowledge that such loss, damage or delay would probably result. ]**

15. This article is intended to introduce necessary limits to the freedom of contract embodied in Article B.

16. The first limit is set for the obligation of seaworthiness. It means that the obligation of seaworthiness should not be lessened or relieved because it is the overriding obligation. When drafting we have referred to Chinese Maritime Code regarding voyage charter parties where the provision regarding obligation of seaworthiness is mandatory.

17. However, if the obligation of seaworthiness is extended to the entire voyage (the words “and during” are currently in square brackets), how to strike a balance between shipowners and cargo interests should be carefully considered when drafting this provision. Apparently, a continuing and mandatory obligation of seaworthiness may impose heavy burden on shipowners under the agreements freely negotiated. Moreover, according to the principle of freedom of contract, we consider the law should introduce minimum limit to the agreement freely negotiated but for public policy. As a tentative conclusion, this Instrument should provide that the obligation, before and at the beginning of the voyage, to exercise due diligence to make the ship seaworthy, is mandatory, however, the obligation during the voyage is non-mandatory, that is to say, two parties may freely negotiated the provisions regarding the obligation of seaworthiness during the voyage. We believe this approach can contribute to striking a new balance between shipowners and cargo interests.

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18. We think this Instrument should not permit the carrier to lessen or relieve from the liabilities resulting from the deviation notwithstanding the agreement is concluded through free negotiation. We also have referred to CMC regarding voyage charter parties when drafting this provision.

19. In addition, we think that the contract should not exempt the liabilities resulting from intention or gross negligence according to the principle of equity. For example, Article 53 of Chinese Contract Law provides: *The following clauses on liability exemption in a contract shall be invalid (1) those causing physical injury to the other party; or (2) those causing losses to property to the other party by intention or due to gross negligence.* We prefer that the instrument should adopt similar provisions to limit the freedom of contract. To assure the consistency of the texts in the Instrument, we don't use the term "intention or gross negligence", instead we think the words already used in this Instrument "the intent to cause the loss, damage or delay in delivery of the goods or recklessly and with knowledge that such loss, damage or delay would probably result" is suitable in this regard. We believe these words means similarly to the term "intention or gross negligence".



## IV. ELECTRONIC COMMERCE

### A. Report of the Working Group on Electronic Commerce on the work of its forty-second session (Vienna, 17-21 November 2003) (A/CN.9/546) [Original: English]

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### I. Introduction

1. At its thirty-third session, in 2000, the United Nations Commission on International Trade Law (UNCITRAL) held a preliminary exchange of views on proposals for future work in the field of electronic commerce. Three topics were suggested as indicating possible areas where work by the Commission would be desirable and feasible: electronic contracting, considered from the perspective of the United Nations Convention on Contracts for the International Sale of Goods<sup>1</sup> (the

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<sup>1</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567

“United Nations Sales Convention”); online dispute settlement; and dematerialization of documents of title, in particular in the transport industry.

2. The Commission welcomed the proposal to study further the desirability and feasibility of undertaking future work on those topics. The Commission generally agreed that, upon completing the preparation of the Model Law on Electronic Signatures, the Working Group would be expected to examine, at its thirty-eighth session, some or all of the above-mentioned topics, as well as any additional topic, with a view to making more specific proposals for future work by the Commission at its thirty-fourth session, in 2001. It was agreed that work to be carried out by the Working Group could involve consideration of several topics in parallel as well as preliminary discussion of the contents of possible uniform rules on certain aspects of the above-mentioned topics.<sup>2</sup> The Working Group considered those proposals at its thirty-eighth session on the basis of a set of notes dealing with a possible convention to remove obstacles to electronic commerce in existing international conventions (A/CN.9/WG.IV/WP.89); dematerialization of documents of title (A/CN.9/WG.IV/WP.90); and electronic contracting (A/CN.9/WG.IV/WP.91).

3. The Working Group held an extensive discussion on issues related to electronic contracting (see A/CN.9/484, paras. 94-127). The Working Group concluded its deliberations on future work by recommending to the Commission that work towards the preparation of an international instrument dealing with certain issues in electronic contracting be started on a priority basis. At the same time, it was agreed to recommend to the Commission that the Secretariat be entrusted with the preparation of the necessary studies concerning three other topics considered by the Working Group: (a) a comprehensive survey of possible legal barriers to the development of electronic commerce in international instruments; (b) a further study of the issues related to transfer of rights, in particular rights in tangible goods, by electronic means and mechanisms for publicizing and keeping a record of acts of transfer or the creation of security interests in such goods; and (c) a study discussing the UNCITRAL Model Law on International Commercial Arbitration,<sup>3</sup> as well as the UNCITRAL Arbitration Rules,<sup>4</sup> to assess their appropriateness for meeting the specific needs of online arbitration (see A/CN.9/484, para. 134).

4. At the thirty-fourth session of the Commission, in 2001, there was wide support for the recommendations made by the Working Group, which were found to constitute a sound basis for future work by the Commission. Views varied, however, as regards the relative priority to be assigned to the different topics. One line of thought was that a project aimed at removing obstacles to electronic commerce in existing instruments should have priority over the other topics, in particular over the preparation of a new international instrument dealing with electronic contracting. It was said that references to “writing”, “signature”, “document” and other similar provisions in existing uniform law conventions and trade agreements had already created legal obstacles and generated uncertainty in international transactions

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<sup>2</sup> *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17)*, paras. 384-388.

<sup>3</sup> United Nations publication, Sales No. E.95.V.18.

<sup>4</sup> United Nations publication, Sales No. E.77.V.6.



conducted by electronic means. Efforts to remove those obstacles should not be delayed or neglected by attaching higher priority to issues of electronic contracting.

5. The prevailing view, however, was in favour of the order of priority that had been recommended by the Working Group. It was pointed out, in that connection, that the preparation of an international instrument dealing with issues of electronic contracting and the consideration of appropriate ways for removing obstacles to electronic commerce in existing uniform law conventions and trade agreements were not mutually exclusive. The Commission was reminded of the common understanding reached at its thirty-third session that work to be carried out by the Working Group could involve consideration of several topics in parallel as well as preliminary discussion of the contents of possible uniform rules on certain aspects of the above-mentioned topics.<sup>5</sup>

6. There were also differing views regarding the scope of future work on electronic contracting, as well as the appropriate moment to begin such work. Pursuant to one view, the work should be limited to contracts for the sale of tangible goods. The opposite view, which prevailed in the course of the Commission's deliberations, was that the Working Group on Electronic Commerce should be given a broad mandate to deal with issues of electronic contracting, without narrowing the scope of the work from the outset. It was understood, however, that consumer transactions and contracts granting limited use of intellectual property rights would not be dealt with by the Working Group. The Commission took note of the preliminary working assumption made by the Working Group that the form of the instrument to be prepared could be that of a stand-alone convention dealing broadly with the issues of contract formation in electronic commerce (see A/CN.9/484, para. 124), without creating any negative interference with the well-established regime of the United Nations Sales Convention (see A/CN.9/484, para. 95), and without interfering unduly with the law of contract formation in general. Broad support was given to the idea expressed in the context of the thirty-eighth session of the Working Group that, to the extent possible, the treatment of Internet-based sales transactions should not differ from the treatment given to sales transactions conducted by more traditional means (see A/CN.9/484, para. 102).

7. As regards the timing of the work to be undertaken by the Working Group, there was support for commencing consideration of future work without delay during the third quarter of 2001. However, strong views were expressed that it would be preferable for the Working Group to wait until the first quarter of 2002, so as to afford States sufficient time to hold internal consultations. The Commission accepted that suggestion and decided that the first meeting of the Working Group on issues of electronic contracting should take place in the first quarter of 2002.<sup>6</sup>

8. At its thirty-ninth session, the Working Group considered a note by the Secretariat discussing selected issues on electronic contracting, which contained an initial draft, tentatively entitled "Preliminary draft convention on [international] contracts concluded or evidenced by data messages" (A/CN.9/WG.IV/WP.95, annex I). The Working Group further considered a note by the Secretariat

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<sup>5</sup> *Official Records of the General Assembly, Fifty-sixth Session, Supplement No.17 (A/56/17)*, para. 293.

<sup>6</sup> *Ibid.*, para. 295.

transmitting comments that had been formulated by an ad hoc expert group established by the International Chamber of Commerce to examine the issues raised in document A/CN.9/WG.IV/WP.95 and the draft provisions set out in its annex I (A/CN.9/WG.IV/WP.96).

9. The Working Group began its deliberations by considering the form and scope of the preliminary draft convention (see A/CN.9/509, paras. 18-40). The Working Group agreed to postpone discussion on exclusions from the draft convention until it had had an opportunity to consider the provisions related to location of the parties and contract formation. In particular, the Working Group decided to proceed with its deliberations by first taking up articles 7 and 14, both of which dealt with issues related to the location of the parties (see A/CN.9/509, paras. 41-65). After it had completed its initial review of those provisions, the Working Group proceeded to consider the provisions dealing with contract formation in articles 8-13 (see A/CN.9/509, paras. 66-121). The Working Group concluded its deliberations on the draft convention with a discussion of draft article 15 (see A/CN.9/509, paras. 122-125). The Working Group agreed that it should consider articles 2-4, dealing with the sphere of application of the draft convention, and articles 5 (Definitions) and 6 (Interpretation), at its fortieth session. The Working Group requested the Secretariat to prepare a revised version of the preliminary draft convention, based on those deliberations and decisions, for consideration by the Working Group at its fortieth session.

10. At its fortieth session, the Working Group was also informed of the progress that had been made by the Secretariat in connection with the survey of possible legal obstacles to electronic commerce in existing trade-related instruments. The Working Group was informed that the Secretariat had begun the work by identifying and reviewing trade-relevant instruments from among the large number of multilateral treaties that were deposited with the Secretary-General. The Secretariat had identified 33 treaties as being potentially relevant for the survey and analysed possible issues that might arise from the use of electronic means of communication under those treaties. The preliminary conclusions reached by the Secretariat in relation to those treaties were set out in a note by the Secretariat (A/CN.9/WG.IV/WP.94) that was submitted to the Working Group at its thirty-ninth session, in March 2002.

11. The Working Group took note of the progress that had been made by the Secretariat in connection with the survey, but did not have sufficient time to consider the preliminary conclusions of the survey. The Working Group requested the Secretariat to seek the views of member and observer States on the survey and the preliminary conclusions indicated therein and to prepare a report compiling such comments for consideration by the Working Group at a later stage. The Working Group took note of a statement stressing the importance that the survey being conducted by the Secretariat should reflect trade-related instruments emanating from the various geographical regions represented on the Commission. For that purpose, the Working Group requested the Secretariat to seek the views of other international organizations, including organizations of the United Nations system and other intergovernmental organizations, as to whether there were international trade instruments in respect of which those organizations or their member States acted as depositaries that those organizations would wish to be included in the survey being conducted by the Secretariat.

12. At its thirty-fifth session, in 2002, the Commission considered the report of the Working Group on the work of its thirty-ninth session. The Commission noted with appreciation that the Working Group had started its consideration of a possible international instrument dealing with selected issues related to electronic contracting. The Commission reaffirmed its belief that an international instrument dealing with certain issues related to electronic contracting might be a useful contribution to facilitate the use of modern means of communication in cross-border commercial transactions. The Commission commended the Working Group for the progress made in that regard. However, the Commission also took note of the varying views that had been expressed within the Working Group concerning the form and scope of the instrument, its underlying principles and some of its main features. The Commission noted, in particular, the proposal that the Working Group's considerations should not be limited to electronic contracts, but should apply to commercial contracts in general, irrespective of the means used in their negotiation. The Commission was of the view that member and observer States participating in the Working Group's deliberations should have ample time for consultations on those important issues. For that purpose, the Commission considered that it might be preferable for the Working Group to postpone its discussions on a possible international instrument dealing with selected issues related to electronic contracting until its forty-first session (New York, 5-9 May 2003).<sup>7</sup>

13. As regards the Working Group's consideration of possible legal obstacles to electronic commerce that might result from trade-related international instruments, the Commission reiterated its support for the efforts of the Working Group and the Secretariat in that respect. The Commission requested the Working Group to devote most of its time at its fortieth session, in October 2002, to a substantive discussion of various issues that had been raised in the Secretariat's initial survey (A/CN.9/WG.IV/WP.94).<sup>8</sup>

14. At its fortieth session (Vienna, 14-18 October 2002), the Working Group reviewed the survey of possible legal barriers to electronic commerce contained in document A/CN.9/WG.IV/WP.94. The Working Group generally agreed with the analysis and endorsed the recommendations that had been made by the Secretariat (see A/CN.9/527, paras. 24-71). The Working Group agreed to recommend that the Secretariat take up the suggestions for expanding the scope of the survey so as to review possible obstacles to electronic commerce in additional instruments that had been proposed for inclusion in the survey by other organizations and explore with those organizations the modalities for carrying out the necessary studies, taking into account the possible constraints put on the Secretariat by its current workload. The Working Group invited member States to assist the Secretariat in that task by identifying appropriate experts or sources of information in respect of the various specific fields of expertise covered by the relevant international instruments.

15. The Working Group used the remaining time at its fortieth session to resume its deliberations on the preliminary draft convention, which it began by a general discussion on the scope of the preliminary draft convention (see A/CN.9/527, paras. 72-81). The Working Group proceeded to consider articles 2-4, dealing with

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<sup>7</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, para. 206.

<sup>8</sup> *Ibid.*, para. 207.

the sphere of application of the draft convention and articles 5 (Definitions) and 6 (Interpretation) (see A/CN.9/527, paras. 82-126). The Working Group requested the Secretariat to prepare a revised text of the preliminary draft convention for consideration at its forty-first session.

16. At its forty-first session (New York, 5-9 May 2003), the Working Group resumed its deliberations on the preliminary draft convention by holding a general discussion on the purpose and nature of the preliminary draft convention (see A/CN.9/528, paras. 28-31). The Working Group noted that a task force that had been established by the International Chamber of Commerce had submitted comments on the scope and purpose of the draft convention (A/CN.9/WG.IV/WP.101, annex). The Working Group generally welcomed the work being undertaken by private sector representatives, such as the International Chamber of Commerce, which was considered to complement usefully the work being undertaken in the Working Group to develop an international convention.

17. The Working Group reviewed articles 1-11 of the revised preliminary draft convention contained in the note by the Secretariat (A/CN.9/WG.IV/WP.100, annex I). The decisions and deliberations of the Working Group with respect to the draft convention are reflected in chapter IV of the report on its forty-first session (see A/CN.9/528, paras. 26-151). The Secretariat was requested to prepare a revised version of the preliminary draft convention, based on those deliberations and decisions, for consideration by the Working Group at its forty-second session (Vienna, 17-21 November 2003).

18. In accordance with a decision taken at its fortieth session (see A/CN.9/527, para. 93), the Working Group also held a preliminary discussion on the question of excluding intellectual property rights from the draft convention (see A/CN.9/528, paras. 55-60). The Working Group agreed that the Secretariat should be requested to seek the specific advice of relevant international organizations, such as the World Intellectual Property Organization (WIPO) and the World Trade Organization, as to whether, in the view of those organizations, including contracts that involved the licensing of intellectual property rights in the scope of the draft convention so as to expressly recognize the use of data messages in the context of those contracts might negatively interfere with rules on the protection of intellectual property rights. It was agreed that whether or not such an exclusion was necessary would ultimately depend on the substantive scope of the convention.

19. The Working Group also exchanged views on the relationship between the draft convention and the Working Group's efforts to remove possible legal obstacles to electronic commerce in existing international instruments relating to international trade within the context of its preliminary review of draft article X, which the Working Group agreed to retain in substance for further consideration.

20. At its thirty-sixth session, in 2003, the Commission took note of the reports of the Working Group on the work of its fortieth (Vienna, 14-18 October 2002) and its forty-first (New York, 5-9 May 2003) sessions (A/CN.9/527 and A/CN.9/528, respectively).

21. The Commission noted the progress made by the Secretariat in connection with a survey of possible legal barriers to the development of electronic commerce in international trade-related instruments. The Commission reiterated its belief in the importance of that project and its support for the efforts of the Working Group

and the Secretariat in that respect. The Commission noted that the Working Group had recommended that the Secretariat expand the scope of the survey to review possible obstacles to electronic commerce in additional instruments that had been proposed to be included in the survey by other organizations and to explore with those organizations the modalities for carrying out the necessary studies, taking into account the possible constraints put on the Secretariat by its current workload. The Commission called on member States to assist the Secretariat in that task by inviting appropriate experts or sources of information in respect of the various specific fields of expertise covered by the relevant international instruments.<sup>9</sup>

22. The Commission further noted with appreciation that the Working Group had continued its consideration of a preliminary draft convention dealing with selected issues related to electronic contracting and reaffirmed its belief that an international instrument dealing with certain issues related to electronic contracting would be a useful contribution that would facilitate the use of modern means of communication in cross-border commercial transactions. The Commission observed that the form of an international convention had been used by the Working Group thus far as a working assumption, but that did not preclude the choice of another form for the instrument at a later stage of the Working Group's deliberations.<sup>10</sup>

23. The Commission was informed that the Working Group had exchanged views on the relationship between the preliminary draft convention and the Working Group's efforts to remove possible legal obstacles to electronic commerce in existing international instruments relating to international trade within the context of its preliminary review of draft article X, which the Working Group had agreed to retain for further consideration (see A/CN.9/528, para. 25). The Commission expressed support for the Working Group's efforts to tackle both lines of work simultaneously.<sup>11</sup>

24. The Commission was informed that the Working Group had, at its forty-first session, held a preliminary discussion on the question of whether intellectual property rights should be excluded from the draft convention (see A/CN.9/528, paras. 55-60). The Commission noted the Working Group's understanding that its work should not be aimed at providing a substantive law framework for transactions involving "virtual goods", nor was it concerned with the question of whether and to what extent "virtual goods" were or should be covered by the United Nations Sales Convention. The question before the Working Group was whether and to what extent the solutions for electronic contracting being considered in the context of the preliminary draft convention could also apply to transactions involving licensing of intellectual property rights and similar arrangements. The Secretariat was requested to seek the views of other international organizations on the question, in particular WIPO.<sup>12</sup>

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<sup>9</sup> Ibid., *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 211.

<sup>10</sup> Ibid., para. 212.

<sup>11</sup> Ibid., para. 213.

<sup>12</sup> Ibid., para. 214.

## II. Organization of the session

25. The Working Group on Electronic Commerce, composed of all States members of the Commission, held its forty-second session in Vienna from 17 to 21 November 2003. The session was attended by representatives of the following States members of the Working Group: Austria, Brazil, Cameroon, Canada, China, Colombia, France, Germany, Hungary, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Lithuania, Mexico, Morocco, Russian Federation, Singapore, Spain, Thailand, Uganda, United States of America and Uruguay.

26. The session was attended by observers from the following States: Algeria, Argentina, Australia, Bahrain, Belgium, Costa Rica, Czech Republic, Denmark, Finland, Indonesia, Ireland, Libyan Arab Jamahiriya, New Zealand, Nigeria, Philippines, Poland, Qatar, Republic of Korea, Serbia and Montenegro, Switzerland, Trinidad and Tobago, Turkey, Venezuela and Yemen.

27. The session was also attended by observers from the following international organizations: (a) organizations of the United Nations system: Economic Commission for Africa, World Bank and United Nations Educational, Scientific and Cultural Organization; (b) intergovernmental organizations: Asian Clearing Union, European Union and Hague Conference on Private International Law; (c) non-governmental organizations invited by the Commission: American Bar Association, Center for International Legal Studies, International Bar Association and International Chamber of Commerce.

28. The Working Group elected the following officers:

*Chairman:* Jeffrey CHAN Wah Teck (Singapore)  
*Rapporteur:* Ligia Claudia González Lozano (Mexico).

29. The Working Group had before it a newly revised version of the preliminary draft convention, which reflected the deliberations of the Working Group at its forty-first session (A/CN.9/WG.IV/WP.103, annex). The Working Group also had before it papers summarizing the research conducted by the Secretariat on some of the main issues that had been discussed by the Working Group in connection with its deliberations on the draft convention (A/CN.9/WG.IV/WP.104 and Add.1-4) and comments received on the draft convention from a task force of the International Chamber of Commerce (A/CN.9/WG.IV/WP.105) and WIPO (A/CN.9/WG.IV/WP.106).

30. The Working Group adopted the following agenda:

1. Opening of the session.
2. Election of officers.
3. Adoption of the agenda.
4. Electronic contracting: provisions for a draft convention.
5. Other business.
6. Adoption of the report.

### III. Summary of deliberations and decisions

31. The Working Group resumed its deliberations on the preliminary draft convention by holding a general discussion on the scope of the preliminary draft convention (see paras. 33-38 below).

32. The Working Group reviewed articles 8 to 15 of the revised preliminary draft convention contained in the annex to the note by the Secretariat (A/CN.9/WG.IV/WP.103). The decisions and deliberations of the Working Group with respect to the draft convention are reflected in chapter IV below.

### IV. Electronic contracting: provisions for a draft convention

#### General comments

33. The Working Group began its deliberations by holding a general exchange of views on the purpose and scope of the preliminary draft convention.

34. The Working Group noted that the text of the preliminary draft convention had been extensively revised and restructured to reflect the Working Group's deliberations at its forty-first session (New York, 5-9 May 2003). The Working Group was reminded that when it had first considered the possibility of further work on electronic commerce after the adoption of the Model Law on Electronic Signatures, it had contemplated, among other issues, a topic broadly referred to as "electronic contracting" and measures that might be needed to remove possible legal obstacles to electronic commerce under existing international conventions. After its review of the initial draft of the preliminary draft convention at its thirty-ninth session (see A/CN.9/509, paras. 18-125) and of the Secretariat's survey of possible legal obstacles to electronic commerce under existing international conventions at its fortieth session (see A/CN.9/527, paras. 24-71), the Working Group had agreed that it should attempt to identify the common elements between removing legal barriers to electronic commerce in existing instruments and a possible international convention on electronic contracting (see A/CN.9/527, para. 30). The Working Group reiterated its understanding that both projects should as much as possible be carried out simultaneously, a working assumption that was reflected in the current text of the preliminary draft convention.

35. The Working Group was reminded of the concerns that had been expressed at its thirty-ninth session concerning the risk of establishing a duality of regimes for contract formation: a uniform regime for electronic contracts under the new instrument and a different, not harmonized regime, for contract formation by any other means, except for the very few types of contract that were already currently covered by uniform law, such as sales contracts falling under the United Nations Sales Convention.

36. The Working Group noted that a task force had been established by the International Chamber of Commerce to develop contractual rules and guidance on legal issues related to electronic commerce, tentatively called "E-terms 2004". The Working Group was informed that the expected outcome of that work would be a pragmatic document, reflecting practical problems and solutions, which would also take into account the different needs of large and small companies. E-terms 2004

would be a voluntary instrument not conflicting with party autonomy. The scope of E-terms 2004 was said to be based on a careful assessment of the practices and needs of companies of various sectors and sizes. Underlying that work was the belief that an international instrument might not be the best way to resolve several problems related to electronic commerce, but rather that legal certainty in electronic contracting could be provided by giving users a combination of voluntary rules, model clauses and guidelines. The advantage of that approach would be its flexibility in that business could take up components of the standards or model clauses that could be amended easily if necessary.

37. The Working Group welcomed the work being undertaken by the International Chamber of Commerce, which was considered to complement usefully the work being undertaken in the Working Group to develop an international convention. The Working Group was of the view that the two lines of work were not mutually exclusive, in particular since the draft convention dealt with requirements that were typically found in legislation and legal obstacles, being statutory in nature, could not be overcome by contractual provisions or non-binding standards. The Working Group expressed its appreciation to the International Chamber of Commerce for the interest in carrying out its work in cooperation with UNCITRAL and confirmed its readiness to provide comments on drafts that the International Chamber of Commerce would be preparing.

38. As regards the organization of the work at the current session, the Working Group agreed that it should focus initially on matters that were common to its efforts of both removing legal obstacles in existing instruments and formulating a broader legal framework for electronic contracting, which were contained in chapter III of the preliminary draft convention.

### **Article 8 [10]. Legal recognition of data messages**

39. The text of the draft article was as follows:

“1. Any communication, declaration, demand, notice or request that the parties are required to make or choose to make [in connection with an existing or contemplated contract] [in the context of the formation or performance of a contract] [, including an offer and the acceptance of an offer,] may be conveyed by means of data messages and shall not be denied validity or enforceability on the sole ground that data messages were used for that purpose.

“[2. Nothing in this Convention requires a person to use or accept information in the form of data messages, but a person’s consent to do so may be inferred from the person’s conduct.]

“[3. The provisions of this article do not apply to the following: [...] [The provisions of this article do not apply to those matters identified by a Contracting State under a declaration made in accordance with article X.]”

40. As a general comment, it was said that draft article 8 was both ambitious and modest in scope. Ambitious because providing that contract-related communications might be conveyed by means of data messages seemed to create a positive enabling rule that went beyond the principle of functional equivalence. Did that mean, for



example, that data messages would always be valid in a contractual context, even though one of the parties might not expect or even wish to entertain data messages? At the same time, however, the draft article was said to be modest in scope, since the last phrase of paragraph 1 was limited to restating the principle of non-discrimination of data messages that had been laid down in article 5 of the UNCITRAL Model Law on Electronic Commerce.<sup>13</sup> The question was asked whether it would not be more useful to go a step further and provide general positive criteria for the validity of data messages.

41. The Working Group agreed that the draft article should not create the impression that it created a substantive rule on the validity of data messages. For that purpose, there was general support for redrafting paragraph 1 in a manner that emphasized more clearly its function as a non-discrimination rule. One possibility to achieve that result might be to replace the phrase “any communication, declaration, demand, notice or request [...] may be conveyed by means of data messages” with a phrase such as “where a communication, declaration, demand, notice or request is conveyed by means of data messages”. The prevailing view within the Working Group, however, was that, as a whole, the paragraph should be retained as a non-discrimination rule and that it should not venture into providing conditions for the legal validity of data messages. Electronic commerce involved the use of various types of communications and technologies and it would not be advisable to attempt to formulate rules or criteria for their validity. Where the law imposed form requirements, draft article 9 already provided criteria for functional equivalence.

42. In connection with the set of alternative words in square brackets, the general preference was for retaining the reference to “existing or contemplated contract”, although there was also support for the alternative reference to “the formation and performance of a contract”, which was felt by some to be more technical. As regards the second set of words in square brackets, the Working Group generally accepted to retain in the text the reference to “offer and acceptance”. The Working Group noted, however, that the inclusion of that phrase in draft article 8 might render paragraph 1 of draft article 13 redundant and decided that it might revisit its decision once it had reviewed draft article 13 (see paras. 117-121 below).

43. The Working Group noted that the purpose of draft paragraph 2 was to state the principle that parties should not be forced to accept contractual offers or acts of acceptance by electronic means if they do not want to do so (see A/CN.9/527, para. 108). However, as the provision was not intended to require that the parties should always agree beforehand on the use of data messages, the second phrase of the draft paragraph provided that a party’s consent might be inferred from its conduct. There was strong support in the Working Group for including a provision such as draft paragraph 2. In that connection, the question was asked whether under the draft article a person that offered goods or services through a letter or a published advertisement would be bound to accept a reply by a data message. In response, it was said that the draft did not affect the way in which the applicable law treated the exchange of communications between the parties. Where the law did not provide a form requirement, it was conceivable that an oral reply to a written offer might constitute a valid reply, in much the same way as a data message would under the draft article. Where a form requirement existed, the draft article was expressing

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<sup>13</sup> United Nations publication, Sales No. E.99.V.4.

a legislative policy choice to ensure the equivalence between data messages and paper-based writings. It was suggested, however, that the second part of the draft paragraph should be deleted, since the word “consent” might be misunderstood to mean consent to the underlying transaction. The Working Group preferred however to retain the entire draft paragraph subject to rephrasing the second sentence so as to reflect the idea that the “consent” referred to therein related only to the use of data messages.

44. There were varying views within the Working Group regarding draft paragraph 3. While there were expressions of support for excluding specific matters from draft article 8, greater support was expressed for limiting any possibility of exclusions to declarations submitted by Contracting States under draft article X. The prevailing view within the Working Group, however, was that it was preferable to limit the possibility of exclusions to exclusions from the entire instrument and not from specific provisions. It was agreed that the draft paragraph should be deleted, since both possibilities contemplated therein were found to be undesirable in view of the importance of the principle of non-discrimination and in the interest of ensuring the widest possible uniformity of law.

45. Subject to the above remarks and amendments, the Working Group generally approved the substance of draft article 8 and requested the Secretariat to prepare a revised version for consideration at its forty-third session.

#### **Article 9 [14]. Form requirements**

46. The text of the draft article was as follows:

“[1. Nothing in this Convention requires a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make [in connection with an existing or contemplated contract] [in the context of the formation or performance of a contract] to be made or evidenced in [a particular form, including written form] [by data messages, writing or any other form] or subjects a contract to any other requirement as to form.]

“2. Where the law requires that a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make in connection with a contract should be in writing, that requirement is met by a data message if the information contained therein is accessible so as to be usable for subsequent reference.

“3. Where the law requires that a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make in connection with a contract should be signed, or provides consequences for the absence of a signature, that requirement is met in relation to a data message if:

“Variant A

“(a) A method is used to identify that person and to indicate that person’s approval of the information contained in the data message; and

“(b) That method is as reliable as appropriate to the purpose for which the data message was generated or communicated, in the light of all the circumstances, including any relevant agreement.

“Variant B

“... an electronic signature is used which is as reliable as appropriate to the purpose for which the data message was generated or communicated, in the light of all the circumstances, including any relevant agreement.

“4. An electronic signature is considered to be reliable for the purposes of satisfying the requirements referred to in paragraph 3 of this article if:

“(a) The signature creation data are, within the context in which they are used, linked to the signatory and to no other person;

“(b) The signature creation data were, at the time of signing, under the control of the signatory and of no other person;

“(c) Any alteration to the electronic signature, made after the time of signing, is detectable; and

“(d) Where the purpose of the legal requirement for a signature is to provide assurances as to the integrity of the information to which it relates, any alteration made to that information after the time of signing is detectable.

“5. Paragraph 4 of this article does not limit the ability of any person:

“(a) To establish in any other way, for the purposes of satisfying the requirement referred to in paragraph 3 of this article, the reliability of an electronic signature;

“(b) To adduce evidence of the non-reliability of an electronic signature.”

47. The Working Group recalled that, in accordance with a suggestion made at the Working Group's thirty-ninth session (see A/CN.9/509, para. 115), article 9 incorporated the general principle of freedom of form contained in article 11 of the United Nations Sales Convention and restated the essential criteria for functional equivalence between data messages and paper documents, in the same manner as article 6, paragraph 2, in respect of writing and article 7, paragraph 3, in respect of signatures of the UNCITRAL Model Law on Electronic Commerce

48. It was also noted that article 9 contained two variants in paragraph 3. Variant A recited the general criteria for the functional equivalence between hand-written signatures and electronic identification methods referred to in article 7 of the UNCITRAL Model Law on Electronic Commerce, whereas variant B, which was more detailed and also included paragraphs 4 and 5, was based on article 6, paragraph 3, of the UNCITRAL Model Law on Electronic Signatures.

### Paragraph 1

49. It was suggested that the draft paragraph could be simplified, since some of its substance was already contained in paragraph 2 of draft article 8. It was suggested that the paragraph should be revised to spell out more clearly that the draft article did not impose expressly or implicitly any form requirements that might affect the

validity of communications or notices but simply provided rules for meeting those requirements, where imposed by the applicable law. It was suggested that paragraph 1 could be redrafted to provide that nothing in the convention subjected a contract or any communication, declaration, demand, notice or request to any requirement as to form. The Working Group agreed that the draft paragraph could be rephrased as suggested.

### **Paragraph 2**

50. The Working Group noted that the draft paragraph set out the criteria for functional equivalence between data messages and paper documents, in the same manner as article 6 of the UNCITRAL Model Law on Electronic Commerce.

51. A suggestion was made that the term “writing” should be defined (see A/CN.9/509, paras. 116 and 117). It was suggested that a possible definition could be taken from the Convention on International Interests in Mobile Equipment and its Protocol on Matters Specific to Aircraft Equipment) adopted on 16 November 2001 by a Diplomatic Conference held in Cape Town, South Africa (the “Cape Town Convention”) which provided that writing meant “a record of information (including information communicated by teletransmission) which is in tangible or other form and is capable of being reproduced in tangible form on a subsequent occasion and which indicates by reasonable means a person’s approval of the record.”

52. That suggestion was objected to on the ground that the technique used in the Cape Town Convention had been to formulate a definition of “writing” that could accommodate the use of data messages. UNCITRAL, by contrast, had chosen to defer to domestic law on the definition of what constituted a “writing” and to provide instead criteria for the functional equivalence between data messages and written documents. That fundamental difference made the definition of writing in the Cape Town Convention unsuitable for being incorporated into the draft Convention.

53. It was suggested that the draft paragraph should include an additional criterion for functional equivalence, namely, that a data message should not be susceptible of being unilaterally altered. In response, it was pointed out that the proposed addition was concerned with ensuring the integrity of the data message and that, as such, it was more akin to the notion of “original” than to the notion of “writing”, since writing requirements were typically concerned with ensuring the existence of an accessible record, but were not necessarily concerned with the integrity of such record. It was noted, in that connection, that the Working Group had not thus far felt the need for adding a provision dealing with the functional equivalence between data messages and “original” records to the draft convention. Legal requirements relating to the production or retention of original records were typically in connection with rules on evidence in court proceedings and in exchanges with the public administration. A functional equivalence rule of that type was not felt to be needed in an instrument that dealt only with exchanges of a commercial nature.

### **Paragraph 3**

54. With respect to variants A and B, concern was expressed that both variants included a requirement relating to the reliability of a signature. It was noted that both draft variant A and variant B were based on the requirements set out in the

UNCITRAL Model Law on Electronic Commerce<sup>13</sup> and the UNCITRAL Model Law on Electronic Signatures<sup>14</sup> respectively. It was noted that some States had not imposed a separate requirement that an electronic signature be reliable provided that it was possible to identify the maker of the signature and the intention by that maker. The Working Group took note of that view.

55. In response to a question concerning the difference between variants A and B, it was pointed out that variant B contained detailed criteria for determining the reliability of an electronic signature. As a result of that, not every electronic signature technique that met the requirements of variant A also met all of the criteria set forth in paragraph 4 of variant B. The reliability of any such signature could however be demonstrated by the interested party under paragraph 5 of variant B.

56. Strong support was expressed for variant A of paragraph 3, which was found to offer simple and technologically neutral criteria for the recognition of electronic signatures.

57. However, the view was expressed that variant A did not ensure a sufficiently high level of security for signature and authentication methods. As it would be preferable to impose higher standards for the security of electronic communications, variant B should be preferred. A suggestion was made to prepare a combination of both variants A and B to accommodate those States that would require a higher degree of specificity as to the requirements of electronic signatures. It was noted that that approach could be accommodated by retaining only variant A as paragraph 3 of article 9 and subsequently including a provision that allowed a declaration to be made by a State under article X that it would not apply paragraph 3 of draft article 9 but would rather apply a higher standard based on a text that reflected variant B. After discussion, however, preference was expressed for retaining variant A only.

58. Subject to the above amendments and comments, the Working Group generally approved the substance of the draft article.

### **Article 10 [11]. Time and place of dispatch and receipt of data messages**

59. The text of the draft article was as follows:

“1. The time of dispatch of a data message is deemed to be the time when the data message enters an information system outside the control of the originator or of the person who sent the data message on behalf of the originator.

“2. The time of receipt of a data message is determined as follows:

“(a) If the addressee has designated an information system for the purpose of receiving data messages, the data message is deemed to be received at the time when it enters the designated information system;

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<sup>14</sup> United Nations publication, Sales No. E.02.V.8.

“(b) If the addressee has designated an information system for the receipt of the data message, but the data message is sent to another information system of the addressee, the data message is deemed to be received at the time when it is retrieved by the addressee;

“(c) If the addressee has not designated an information system, the message is deemed to be received at the time when the data message enters an information system of the addressee unless ...

“[Variant A

“... it was unreasonable for the originator to have chosen that particular information system for sending the data message, having regard to the circumstances of the case and the content of the data message.] [or]

“[Variant B

“... the addressee could not reasonably expect that the data message would be addressed to that particular information system.]

“3. Paragraph 2 of this article applies notwithstanding that the place where the information system is located may be different from the place where the data message is deemed to be received under paragraph 5 of this article.

“4. When the originator and the addressee use the same information system, both the dispatch and the receipt of a data message occur when the data message becomes capable of being retrieved and processed by the addressee.

“5. A data message is deemed to be dispatched at the place where the originator has its place of business and is deemed to be received at the place where the addressee has its place of business, as determined in accordance with article 7.”

60. The Working Group recalled that, except for draft paragraph 4, the rules contained in the draft article were based on article 15 of the UNCITRAL Model Law on Electronic Commerce, with some adjustments to harmonize the style of the individual provisions with the style used elsewhere in the draft convention. It was further recalled that draft paragraphs 1 and 2 had been redrafted, as their previous formulation had been felt to be unclear (see A/CN.9/528, paras. 140, 148 and 149). The Working Group also took note of the paper prepared by the Secretariat on, *inter alia*, the time of receipt and dispatch of data messages and contract formation (A/CN.9/WG.IV/WP.104/Add.2), which considered domestic legislative provisions dealing with the time when a data message should be considered to have been dispatched and received.

### **Paragraphs 1 and 2**

61. The Working Group noted that one of the main objectives of the draft convention was to provide guidance that allowed for the application, in the context of electronic contracting, of concepts traditionally used in international conventions and domestic law, such as “dispatch” and “receipt” of communications. To the extent that those traditional concepts were essential for the application of rules on contract formation under domestic and uniform law, the provision of functionally

equivalent concepts for an electronic environment was said to be an important objective of the draft convention. There was strong support for that objective and, in general, for the idea that the matter should be addressed in the draft convention.

62. The Working Group was reminded, however, that it had had extensive discussions on draft paragraphs 1 and 2 at its thirty-ninth and forty-first sessions (see A/CN.9/509, paras. 93-98 and A/CN.9/528, paras. 137-151, respectively). The concerns that had been raised in connection with those provisions related mainly to criticism regarding the meaning of the expression “information systems”, and the perceived complexity of the draft article, in particular in view of the distinction between “designated” and “non-designated” information systems. The Working Group was invited to consider proposals for addressing those concerns.

63. Pursuant to one view, the main problem posed by the draft article, as had been said in earlier sessions of the Working Group, was its reliance on the notion of “information system” to determine time of dispatch and receipt of data messages. That solution was said to be inappropriate in an essentially intangible environment since the notion of an information system might be understood to imply the existence of equipment to transmit and process data messages. As an alternative to the notion of an information system, it was proposed that the draft article should focus on the control of a data message to determine the time of dispatch and receipt of data messages.

64. On that basis, it was suggested that paragraphs 1 and 2 of article 10 should provide that a data message was sent when it first left the control of the originator and was sent in a manner to which the addressee had consented. Furthermore, a message should be deemed to have been received when it became capable of being retrieved and processed by the addressee or, if it was sent in a manner other than proposed by the addressee, when the addressee became aware of it.

65. Another proposal put forward to the Working Group was to replace the entirety of draft article 10 with the following text:

“1. The time of dispatch of a data message shall be deemed to be the time when the data message enters an information system outside the control of the originator or of the person who sent the data message on behalf of the originator.

“2. The time of receipt of a data message shall be deemed to be the time when it becomes capable of being retrieved by the addressee or by any other person named by the addressee.

“[3. The time of receipt of a data message sent to an automated information system shall be deemed to be the time when it becomes capable of being processed by the automated information system.]”

66. The Working Group heard expressions of strong support for those proposals, which were welcomed as a good basis for further discussion by the Working Group. It was said that replacing the various factual situations referred to in draft paragraph 2 with simple general rules that focused on the control over a data message or the capability of retrieving a data message offered a better solution for a uniform law instrument.

67. It was noted that the different criteria for determining receipt of data messages that were used in subparagraphs (b) and (c) of paragraph 2 might lead to conflicting results. For example, if “information system” covered systems that carried data messages to their addressees, including, for instance, an external server, a data message might be deemed to have been received by the addressee under subparagraph (c) even if it was lost prior to retrieval, as long as the loss had occurred after the message had entered the server’s system and that system was a “designated information system”. Under subparagraph (b), however, the lost message would not be deemed to have been received by the addressee on the grounds that it had not been actually retrieved by the addressee simply because the server’s information system had not been “designated” by the addressee. It was said that there was no justification for that discrepancy, which was only due to the complexity of the draft paragraph.

68. Another advantage of formulating alternative rules along the lines of the proposals that had been tabled was to avoid reliance on the notion of “information system”, which was felt to be ambiguous and possibly leading to conflicting results depending on whether it was meant to include, for example, a mailbox, a company’s server, an external server, or a closed network or all or only some of those elements. The proposed reference to the moment when a message became capable of being retrieved provided instead sufficient elements for a court or an arbitral tribunal to determine when a message had been effectively received, should there be an argument about that question.

69. In response, it was pointed out that the search for simplicity, a characteristic that, in itself, could appeal to the business community, should not lead those drafting the convention to disregard the need to ensure a high level of predictability and certainty with respect to contract formation. It was strongly felt that, on such important issues as the time and place of contract formation, the need for certainty was paramount. In that respect, the alternatives proposed to draft paragraphs 1 and 2 were found to be vague and insufficient to meet the practical needs of users of electronic commerce. The originator of a data message, it was said, had no means of ascertaining when a message that had entered an information system outside the originator’s control became capable of being retrieved from that system. By removing the factual element linked to a message’s entry into a given information system, the alternative proposals eliminated the only objective factor available to the parties to establish beforehand the time their messages would become effective. The draft article should aim at avoiding possible doubt and the related potential for litigation, rather than merely offering rules that could be applied a posteriori to solve a dispute resulting from uncertainty as to the time of receipt of a data message. If the notion of “information system” posed problems, it would be preferable to refine the definition contained in subparagraph (e) of draft article 5, rather than to abandon that useful notion.

70. Another objection to the alternative proposals was that they seemed to eliminate the notion of “designated information system”. It was important, however, to preserve that notion, since it allowed the parties to choose a specific information system for receiving certain communications, for instance, where an offer expressly specified the address to which acceptance should be sent. Such a possibility was said to be of great practical importance, in particular for large corporations using various communication systems at different places, which could not be expected to



pay the same level of attention to all the information systems it had established. It would be unreasonable, for example, to bind a large corporation by the content of data messages sent to just any of its various electronic mailboxes simply because such a message had become “capable of being retrieved” by the corporation.

71. Furthermore, it was pointed out that draft paragraphs 1 and 2 were based on tested solutions contained in article 15 of the UNCITRAL Model Law on Electronic Commerce,<sup>13</sup> which had already been incorporated in the domestic legislation of several jurisdictions. Those solutions were said to protect the interests of the originator, who would otherwise be left to the mercy of the addressee’s willingness to become aware of a data message or of the possible malfunctioning of the addressee’s system. The alternative proposals under consideration were said to provide the opposite solution, by placing on the originator the entire burden of proof of the receipt of a data message. As a matter of principle, however, the Working Group should not deviate from the policy it had established in earlier texts, with the Commission’s approval, without a demonstrated need for a shift in policy.

72. The Working Group considered at length the various views that had been expressed on the draft paragraphs. A widely shared view was that the alternative proposals before the Working Group had positive elements that deserved further consideration and that those proposals might be helpful to address some of the concerns that had been expressed in connection with paragraphs 1 and 2. There was at the same time growing awareness that those proposals lacked positive elements to help determine when a message became effective, which were currently provided by the notion of “entry” into an information system. The Working Group also noted that, however complex the distinction between “designated” and “non-designated” systems appeared to be, that distinction served a useful practical purpose, since an addressee should not be deemed to have received messages that were sent to an information system where the addressee did not reasonably expect to receive them.

73. One possibility for addressing those concerns, it was suggested, might be to combine some of the elements that had been proposed with parts of the existing text in a manner that created a presumption of awareness of a message (in the sense of “accessibility” or “possibility of knowledge”) by its entry in an information system of the addressee, provided that the choice of that system by the originator was reasonable. Such a new version of draft paragraph 2, it was said, might read along the following lines:

“The time of receipt of a data message shall be deemed to be the time when it becomes capable of being retrieved by the addressee or by any other person named by the addressee. A data message is presumed to be capable of being retrieved by an addressee when it enters an information system of the addressee, unless it was unreasonable for the originator to have chosen that particular information system for sending the data message, having regard to the circumstances of the case and the content of the data message.”

74. The Working Group generally agreed that the proposed new version of draft paragraph 2 provided a good basis for solving the problems that the Working Group had identified. It was pointed out that the notion of capability of retrieving a data message, when linked to the time when a message entered an information system of the addressee, effectively transposed to an electronic environment the notion that in order to become effective, a contractual communication had to reach the addressee

by entering the addressee's sphere of control, a notion that was implicit, for instance, in article 24 of the United Nations Sales Convention. Thus, the new proposal would lead in fact to the same result as the various situations contemplated in article 15, paragraph 2, of the UNCITRAL Model Law on Electronic Commerce,<sup>13</sup> albeit through a different formulation. In response to an objection that the new proposal omitted reference to the parties' agreement to use a particular means of communication, it was pointed out that questions related to a party's consent to conduct transactions electronically was envisaged in draft article 8, paragraph 2. The choice of a particular means of electronic communication, on the other hand, was a possibility implicitly contemplated in the test of reasonableness contained in the last part of the new proposal. In fact, the new proposal preserved the right of the addressee to choose a particular information system for the receipt of data messages, since the addressee would be able, for example, to challenge the choice of a particular electronic address by the originator on the grounds that such a choice disregarded the addressee's designation of another system, being therefore unreasonable.

75. In the light of the above, the Working Group generally agreed that the proposed new formulation could replace the existing draft paragraph 2 and should be retained as a basis for the Working Group's future review of the matter. The Working Group noted, however, that it might still need to revisit the definition of "information system" in draft article 5 with a view to ensuring that it adequately covered the factual situations to which draft article 10 applied.

76. Having accepted in principle the reformulation of draft paragraph 2, the Working Group turned its attention again to paragraph 1. The view was expressed that the criterion used in the draft paragraph for determining the time of dispatch of data messages was inadequate, since the dispatch was defined as the time a data message entered an information system outside the control of the originator. It would be more logical, however, to provide that a message was deemed to be dispatched when it left the originator's sphere of control or, to use the terminology of the draft convention, when it left an information system under the control of the originator. There was strong support for that proposition, which was felt to be more in line with the notion of dispatch than the current formulation.

77. However, there were also strong reservations to changing the criterion currently used in the draft paragraph. It was pointed out that exit from an information system under the control of the originator and entry into another information system not under the originator's control were two sides of the same factual situation, since a message typically left one information system by entering another one. The current formulation, which was also used in article 15, paragraph 1, of the UNCITRAL Model Law on Electronic Commerce,<sup>13</sup> was said to be preferable because it focused on an element in respect of which the parties would have easily accessible evidence, since transmission protocols of data messages typically indicated the time of delivery of messages to the destination information system or to intermediary transmission systems, but did not normally state when messages left their own systems.

78. In the light of the above, the Working Group agreed that paragraph 1 could contain both alternatives, within square brackets, for consideration by the Working Group at a later stage.

79. Subsequently, after having completed its deliberations on draft paragraph 4 (see para. 83 below) the Working Group agreed that paragraph 1 could be reformulated along the following lines, for future consideration:

“The time of dispatch of a data message is deemed to be the time when the data message [enters an information system outside the control of the originator or of the person who sent the data message on behalf of the originator] [leaves an information system under the control of the originator or of the person who sent the data message on behalf of the originator], or, if the message had not [entered an information system outside the control of the originator or of the person who sent the data message on behalf of the originator] [left an information system under the control of the originator or of the person who sent the data message on behalf of the originator], at the time when the message is received.”

80. The Working Group took note, in that connection, of suggestions to improve the drafting of paragraph 1, including the proposal that the words “is deemed to be the time” should be replaced with the words “is the time”. Another suggestion was that those words should be replaced with the words “is presumed to be”.

### **Paragraph 3**

81. The question was asked whether the draft paragraph was needed in the context of the draft convention, since matters of timing were dealt with in paragraph 2 and the location of the parties was a matter dealt with in paragraph 5. In response, it was observed that the draft article was only intended to clarify that receipt of a data message might occur even if the place where the message was received (that is the place of the information system into which the message had entered) did not coincide with the parties’ places of business. Such a clarification was useful in an electronic environment since, unlike the normal situation for postal communications that were usually delivered at a party’s premises, data messages could be deemed to be received when delivered to information systems that were located outside of a party’s place of business.

82. Subject to a proposal for placing draft paragraph 3 after the current paragraph 5, the Working Group approved the substance of the draft paragraph.

### **Paragraph 4**

83. It was suggested that paragraph 4 should be deleted since the notion of receipt of a data message upon its becoming capable of being retrieved was now contained in the new version of paragraph 2 (see para. 73 above). It was pointed out, however, that paragraph 2 only dealt with the receipt of a data message, whereas paragraph 4 also established rules for the dispatch of a message when both parties were within the same information system. Having considered those views, the Working Group agreed that the rules on dispatch contained in paragraph 4 could be incorporated into paragraph 1 (see paras. 76-80 above) and that paragraph 4 could be deleted for the time being. The Working Group did not reach consensus on whether the notion of messages within the same information system was realistic or significant.

**Paragraph 5**

84. No comments were made in connection with the draft paragraph, which was generally approved by the Working Group.

**Proposed additional paragraph**

85. It was suggested that draft article 10 did not provide an appropriate rule for receipt involving communication of data messages using automated information systems. It was suggested that in dealing with that matter, the Working Group should consider that contract negotiations through an automated information system (for example, the sale of aeroplane tickets) largely reflected the pattern of “face to face” or “instantaneous” communications. On that basis, it was suggested that a data message sent to an automated information system should be considered to be received when it became capable of being processed by the automated information system. It was suggested that that proposed amendment covered the situation where a data message was processed without any further interaction of the addressee who administered the automated information system.

86. It was agreed that the question of automated information systems could be deferred until the Working Group considered draft article 14. In that respect, the Working Group was cautioned against creating a different rule in respect of automated information systems from that which applied generally for the receipt of data messages. It was also suggested that the new version of paragraph 2 (see para. 73 above) possibly already covered the receipt of data messages by automated information systems. On that basis, the Working Group agreed to revisit the issue of automated information systems in the context of its discussions on draft article 14.

**Article 11 [15]. General information to be provided by the parties**

87. The text of the draft article was as follows:

“[Data messages used for the advertisement or offer of goods or services shall include the following information:

“(a) The name of the party on whose behalf the advertisement or offer is made and, for legal entities, its full corporate name and place of registration, organization or incorporation;

“(b) The geographic location and address at which that party has its place of business, including its electronic mail address and other contact details.]”

88. The Working Group noted that the draft article, which was inspired by article 5, paragraph 1, of Directive 2000/31/EC of the European Union (the “European Union Directive”), appeared in square brackets, as there was no consensus on the need for the provision within the Working Group (see A/CN.9/509, paras. 61-65). In its current form, the draft article did not contemplate any sanctions or consequences for a party’s failure to provide the required information, a matter that still needed to be considered by the Working Group (see A/CN.9/509, para. 123, and A/CN.9/527, para. 103).

89. The Working Group noted that the draft article had given rise to extensive debate at its thirty-ninth session, when it had been found to be highly desirable by a

large number of delegations and highly controversial by an equivalent number of delegations (A/CN.9/509, paras. 60-65). That division of views was again evident at the current session.

90. There were strong expressions of support for the draft article, which was said to embody important elements to help the parties determine whether a particular transaction would be regarded as domestic or international and to take measures necessary to protect their rights, in particular in the event of disputes or litigation. The draft article, it was said, could not be seen as excessively intrusive and did not impose an unreasonable burden on business entities, since the information contemplated therein was of a general nature and not concerned with a company's internal affairs. Business entities pursuing legitimate commercial activities should have no reason to fear disclosing their identities or their places of business.

91. Furthermore, the fact that international instruments on uniform commercial law did not contain similar obligations for transactions conducted through traditional means did not impede the creation of specific requirements for transactions concluded electronically. Electronic commerce was a relatively new phenomenon that might justify new legal rules. In a non-electronic environment, it would be hardly conceivable to have a contract concluded between parties that did not know each other's identities or locations. It was pointed out, however, that certain negotiation techniques, such as web contracting, might allow complete contract performance and payment without the parties having any access to information beyond the data messages they exchanged. Legal certainty, transparency and confidence in electronic commerce would be enhanced by the promotion of good business standards, such as basic disclosure requirements. If the provision was felt to be excessively rigid, it could be rendered more flexible and the sanctions, if any, could be left to the applicable law. The regulatory appearance of the draft article might be further mitigated if the reference to "advertisements", which might seem to impinge upon the domain of consumer protection and publicity regulation, would be eliminated. As a whole, however, the draft article should be retained.

92. The countervailing view, which also received strong support, was that the draft article was regulatory in nature, ill placed in a commercial law instrument, unduly intrusive and potentially harmful to certain existing business practices. Disclosure obligations such as those contemplated by the draft article were typically found in legal texts that were primarily concerned with consumer protection, as was the case in the European Union Directive on which the draft provision was based. In the case of those other instruments, however, the operation of regulatory provisions of that type was supported by a number of administrative and other measures that could not be provided in the draft convention.

93. It was also argued that no similar obligations existed for business transactions in a non-electronic environment and the interest of promoting electronic commerce would not be served by subjecting it to such special obligations. Moreover, in particular situations, such as in certain financial markets or in business models such as Internet auction platforms, it was common for both sellers and buyers to identify themselves only through pseudonyms or codes throughout the negotiating or bidding phase. There were also systems that involved trading intermediaries where the identity of the ultimate supplier would not be disclosed to the potential buyers. The parties in those cases had various legitimate reasons for keeping their identities secret, including their negotiating strategy, rather than being reluctant to disclose

their names or places of business for improper motive or out of fear of legal sanctions. Besides, a provision such as the draft article was said to be ineffective, whatever purpose might be attached to it. Under most circumstances, the parties would have a business interest in disclosing their names and places of business, without needing to be required to do so by law. Thus, the draft convention would be innocuous for the purpose of enhancing legal certainty. If, however, the purpose was to curb fraud and create obstacles to illicit use of electronic commerce, the draft convention was not an efficient mechanism, since it could not be accompanied by the types of sanctions that might be a deterrent for wrongdoers. An additional note of caution was that the draft article should not be perceived as attempting to establish rules on jurisdiction, which was a matter outside the scope of the draft convention.

94. The Working Group considered at length the various views that had been expressed. There was general agreement with the overall aim of developing rules or principles that helped enhance legal certainty and foster confidence in electronic commerce, for instance by promoting transparency and helping the parties obtain the means to determine which law governed their transactions. However, in view of the opposing views on the desirability and usefulness of the draft article, the Working Group was invited to consider possible alternatives that might help achieve a compromise on the matter.

95. One such alternative, it was said, might be to reformulate the draft paragraph as an invitation or exhortation to business parties to disclose the information referred to therein, for example, by replacing the words “shall include the following information” with the words “may include the following information”. That proposal was objected to on the ground that it would render the entire article optional, thus defeating the purpose of ensuring a minimum amount of information. Another suggestion was to subject the draft article to the principle of party autonomy in such a manner that a party that proceeded to conduct commercial transactions with another party that had not disclosed its identity or place of business might be deemed to have accepted to waive the requirements of draft article 11. That proposal, too, was criticized since it might lead to conflicts with domestic or regional regulatory regimes that required the disclosure of the information contemplated in the draft article without authorizing the parties to displace those requirements.

96. Further options to address the objections that had been raised to the draft article included proposals for exclusion of particular situations, for instance when the parties negotiated in closed networks to which they had gained access upon initial identification, or when the parties already had a history of previous dealings or were otherwise satisfied that the required information had been made or could be made available to them. In response, however, it was said that it would be difficult to define what those particular situations were and that, in any event, they would not accommodate absolute anonymity. Furthermore, the examples of business models where the parties acted through pseudonyms, such as Internet auction platforms, were most commonly used by consumers, whose interests were otherwise protected through specific regulations.

97. The view was expressed, in that connection, that the problems raised by the draft article stemmed at least in part from its apparently mandatory nature. Those problems, it was said, could be avoided if the article was reformulated as a hortatory

provision to the effect that the parties should refrain from making false statements as to their identities or location. Another related proposal was that, to avoid the issues related to the possible sanctions to a party's failure to disclose information, the draft article could include a provision similar to paragraph 2 of articles 8 and 9 of the UNCITRAL Model Law on Electronic Signatures,<sup>14</sup> which provided that the parties bore the legal consequences of their failure to comply with those provisions. There were objections to those proposals, however, on the grounds that a reference to possible sanctions under domestic law was not conducive to enhancing legal certainty and that a hortatory provision against fraudulent misrepresentations was not compatible with the commercial law character of the draft convention.

98. Another problem identified in the draft article in the course of the discussion was that it imposed a disclosure obligation only upon the party offering goods or services, but not on the other contracting partner. That, it was said, was evidence of the original purpose of the provision, which was said to be primarily related to consumer protection. In response, it was noted that the focus on the party offering goods or services was a logical choice in the draft article, since that was the party that was aiming at reaching a potentially wide number of persons. It would be for the offeror to set up its negotiating system in such a way that it provided means for the interested parties to provide their own information details or required them to do so. In any event, however, as the party acting upon an offer might be prompted, for example, to make immediate payment or disclose personal information, or might have a legitimate interest in obtaining information needed to protect its rights, for instance in the event of litigation, it was reasonable for the draft article to focus on disclosure obligations for the party making the initial offer.

99. The view was expressed that none of the existing proposals was sufficient to solve the problems posed by the draft article, which might need to be extensively restructured or deleted. It was suggested, in that connection, that articles 1 and 7 already offered an acceptable framework for determining the location of the parties and that no additional information would be needed in order to determine the law governing a particular contract.

100. In the interest of rendering the draft article more flexible, it was proposed, at that juncture, to reformulate the draft article as an optional provision along the following lines:

“1. Before any contract is made final each party shall disclose to each other party:

- (a) Its legal name or identity;
- (b) The place from which it is contracting; and
- (c) A method of contacting the party by electronic means.

“2. The disclosure under paragraph 1 is not required if parties have contracted with each other previously or otherwise can be presumed to know the information referred to in paragraph 1.

“3. If a party fails to comply with the above requirements, this convention does not apply to the contract.”

101. The Working Group was appreciative of the efforts made to achieve a workable consensus on the matter. However, the new proposal also attracted

criticism both from those who supported draft article 11 and from those who sought its deletion. On the one hand, there were objections to the proposal because it rendered optional the compliance with requirements that should be treated as a matter of public policy and that should, therefore, be mandatory. On the other hand, the proposal was said to defeat the very purpose of the draft convention, as it would automatically exclude from the benefit of enhanced uniformity and legal certainty provided by the draft convention all contracts that were concluded in contravention to article 11.

102. Having regard to the persisting disagreement within the Working Group on the draft article, it was suggested that the matter might be addressed from a different angle, namely by a provision that recognized the possible existence of disclosure requirements under the substantive law governing the contract and reminded the parties of their obligations to comply with such requirements. Such a provision might be placed at an appropriate place in chapter I or II of the draft convention and might read as follows:

“Nothing in this Convention affects the application of any rule of law that may require the parties to disclose their identities, places of business or other information, or relieves a party from the legal consequences of making inaccurate or false statements in that regard.”

103. There was wide agreement within the Working Group that the proposed new approach for dealing with disclosure requirements constituted a good basis for establishing a consensus on the matter. It was pointed out that the new proposal had the advantage of highlighting the parties' obligations to comply with domestic law before using data messages for contracting purposes. Although the proposal would entail the deletion of the current draft article 11, it would restate the principle that parties should be reminded of good practices when contracting electronically. It was further pointed out that the new approach would avoid conflicts between mandatory disclosure obligations under domestic law and similar obligations under the convention, in particular if, in the latter case, those obligations could be derogated by the agreement of the parties, as had been suggested earlier in the course of the deliberations, since that right was not always provided under domestic law. The Working Group took note of the view, however, which was not isolated, that it would have been preferable for the draft convention itself, as a uniform law instrument, to provide disclosure obligations, rather than defer completely to domestic law on the issue.

104. In that connection, the Working Group debated at some length the question of whether the new proposed provision would be subject to party autonomy under draft article 4 and whether a specific exception should be included in draft article 4. The general understanding of the Working Group was that, given the nature of the new provision, which deferred to domestic law on disclosure requirements, domestic requirements would remain applicable even if the parties attempted to escape those requirements by excluding the application of the new provision.

105. Subject to a final decision by the Working Group, at a later stage, on a suitable place for inserting the new provision, the Working Group agreed to incorporate the new provision and to delete draft article 11.



## Article 12 [9]. Invitations to make offers

106. The text of the draft article was as follows:

“Variant A

“1. A proposal to conclude a contract made through one or more data messages which is not addressed to one or more specific persons, but is generally accessible to persons making use of information systems is to be regarded merely as an invitation to make offers, unless it indicates the intention of the person making the proposal to be bound in case of acceptance.

“2. Unless otherwise indicated by the person making the proposal, a proposal to conclude a contract that makes use of interactive applications for the [automatic] placement of orders through such information system, is an offer and is presumed to indicate the intention of the offeror to be bound in case of acceptance.

“Variant B

“A proposal to conclude a contract made through one or more data messages which is not addressed to one or more specific persons, but is generally accessible to parties making use of information systems, including proposals that make use of interactive applications for the [automatic] placement of orders through such information system, is to be regarded as an invitation to make offers, unless it clearly indicates the intention of the person making the proposal to be bound in case of acceptance.”

### General remarks

107. The Working Group was invited to begin its deliberations by considering whether there was a need for a default rule to determine when a party that made a proposal to conclude a contract using data messages should be deemed to have made a binding offer and under what circumstances the parties could be deemed to be bound by offers made using automated systems. It was noted that the provision was inspired by article 14, paragraph 1, of the United Nations Sales Convention and resulted from an analogy between offers made by electronic means and offers made through more traditional means (see A/CN.9/509, paras. 76-85). It was recalled that the general rule in paragraph 1 of variant A and in variant B had reflected the principle that a party that offered goods or services through data messages that were not addressed to one or more specific persons should not be deemed to have made a binding offer, unless it clearly indicated otherwise. Underlying that general rule was the concern that attaching a presumption of binding intention to the use of interactive contracting applications would be detrimental for sellers holding a limited stock of certain goods, if the seller were to be liable to fulfil all purchase orders received from a potentially unlimited number of buyers.

108. It was noted that paragraph 1 of variant A simply restated the general principle that offers of goods or services that were accessible to an unlimited number of persons were not binding, but were to be regarded as invitations to make offers, whereas paragraph 2 of that variant provided that, as an exception to the general rule in paragraph 1, when an interactive application was used, that should be regarded as a binding offer. Variant B, which combined paragraphs 1 and 2 into a

single provision, treated offers of goods or services, even where an “interactive application” was used, as an invitation to make offers (see A/CN.9/528, paras. 110-119).

109. In examining the draft article, the Working Group was informed of the way in which traditional notions of offer and acceptance had been applied to contract negotiations through electronic means in the context of relevant legal writings and case law. It was noted that there was a strong view in legal writing suggesting that the “invitation to treat” model might not be appropriate for uncritical transposition to an Internet environment and that distinctions should be drawn between web sites offering goods or services using interactive applications and those using non-interactive applications (see A/CN.9/WG.IV/WP.104/Add.1, paras. 4-7). The Working Group also noted that some case law seemed to support the view that offers made by so-called “click-wrap” agreements and in Internet auctions might be interpreted as binding.

#### **Choice between variants A and B**

110. Some support was expressed that the article should be deleted. It was said that, in attempting to deal with issues of substantive law related to contract formation, the article went beyond the stated aim of the draft convention to facilitate electronic transactions. It was further said that the article did not offer a meaningful supplement to rules already found in the United Nations Sales Convention and was therefore a redundant provision. Notwithstanding that view, the Working Group eventually agreed that it would be useful for the draft convention to offer some clarification on the matter and that the options in the draft article provided a good starting point to achieve that objective. It was observed in that connection that the provision was a default rule that appropriately adapted a rule from the United Nations Sales Convention to the electronic context.

111. As a general comment, it was observed that a proposal to conclude a contract only constituted an offer, in accordance with article 14, paragraph 1, of the United Nations Sales Convention, if a number of conditions were fulfilled, including that the proposal should be sufficiently definite by indicating the goods and expressly or implicitly fixing or making provision for determining the quantity and the price. It was important to review the draft article with a view to ensuring that it did not create the impression that the party’s intention to be bound would suffice to constitute an offer in the absence of those other elements. The Working Group took note of that comment and agreed that the comments should be taken into account in a future version of the draft article.

112. Support was expressed for variant A on the basis that it allowed a broad range of possibilities and allowed for the operation of the intention of the parties. However, concern was expressed that paragraph 2 of variant A presumed that persons using interactive applications to make offers always intended to make binding offers, a proposition that did not reflect the prevailing practice in the marketplace. Thus, if variant A was retained, as suggested, paragraph 2 should be deleted. In response to that proposal, however, it was observed that there existed business models based on the rule that offers through interactive applications were binding offers. In those cases, possible concerns about the limited availability of the relevant product or service were addressed by including disclaimers stating that the

offers were for a limited quantity only and by the automatic placement of orders according to the time they were received.

113. The prevailing view within the Working Group was contrary to the policy stated in paragraph 2 of variant A. However, since paragraph 1 of variant A alone was felt to provide little help to the interpretation of the relevant rules in the United Nations Sales Convention, the Working Group took the view that working on the basis of variant B would be a preferable option.

114. In respect of variant B, concern was expressed that the use of the term “interactive applications” was too narrow and was not consistent with other provisions of the draft convention, which used the term “automated information systems”. In response, it was recalled that at the Working Group’s thirty-ninth session, it had been decided that, in the context of the draft article, the expression “automated information system” did not offer meaningful guidance since the party that placed an order might have no means of knowing how the order would be processed and to what extent the information system was automated. The notion of “interactive applications”, in turn, was considered to be an objective term that better described a situation apparent to any person accessing the system, namely that it was prompted to exchange information through that system by means of immediate actions and responses having an appearance of automaticity. It was noted that the term was not a legal term but rather a term of art highlighting that the provision focused on what was apparent to the party activating the system rather than on how the system functioned internally. On that basis, the Working Group agreed that the term “interactive applications” could be retained.

115. A concern was raised that the reference to the term “an invitation to make offers” was not appropriate since it was not familiar to some legal systems. It was proposed that a more neutral approach might be to replace the words “is to be regarded as an invitation to make offers” with words such as “is not to be regarded as making an offer”. While some support was expressed for that proposal, it was noted that the draft text mirrored language used in article 14, paragraph 2, of the United Nations Sales Convention and that the Working Group should not depart from that language in the present convention. For the same reason, suggestions that the word “clearly” in variant B should be deleted were withdrawn on the basis that the term was also used in the United Nations Sales Convention.

116. The Working Group concluded its deliberations on the draft article by agreeing to retain variant B as a basis for future consideration.

### **Article 13 [8]. Use of data messages in contract formation**

117. The text of the draft article was as follows:

“1. [An offer and the acceptance of an offer may be expressed by means of data messages.] Where data messages are used [in the formation of a contract] [to convey an offer or the acceptance of an offer], [that contract] [the resulting contract] shall not be denied validity or enforceability on the sole ground that data messages were used for that purpose.

## “Variant A

“2. When conveyed in the form of a data message, an offer and the acceptance of an offer become effective when they are received by the addressee.

## “Variant B

“2. Where the law of a Contracting State attaches consequences to the moment in which an offer or an acceptance of an offer reaches the offeror or the offeree, and a data message is used to convey such offer or acceptance, the data message is deemed to reach the offeror or the offeree when it is received by the offeror or the offeree.”

118. The Working Group noted that the draft article contained a number of provisions concerning the effectiveness of data messages used to convey contractual offers or acceptances. Those provisions, it was pointed out, had been originally contained, albeit using a different formulation, in an earlier version of the draft convention. That version reflected the essential rules on contract formation of the United Nations Sales Convention. The original draft article had been the subject of extensive debate and considerable criticism at the Working Group’s thirty-ninth session, when the Working Group agreed that the provision should be reformulated and that any substantive provisions in the draft convention should be limited to those which were strictly required to facilitate the use of data messages in the formation of international contracts (see A/CN.9/509, paras. 87-92). The draft provision had been subsequently reviewed by the Working Group at its forty-first session. At that time, the Working Group had not been able to reach an agreement on whether the draft article should be retained or deleted. Having considered the view that the draft article contained useful provisions to facilitate a determination on the formation of a contract by electronic means, the Working Group agreed to request the Secretariat to reformulate the draft article for consideration at a later stage (see A/CN.9/528, paras. 94-108). The current version of the draft article, in particular paragraph 2, reflected suggestions that had been made at that session (see A/CN.9/528, paras. 105 and 106).

119. At the current session, strong objections were repeated to retaining the draft article as a whole. It was pointed out that the provision did not specifically address the issues of electronic contracting, to which the draft convention should confine itself. Even in its current form, which was meant to be limited in scope to electronic commerce transactions, the draft article should still be deleted. If the purpose of draft paragraph 1, for instance, was to facilitate a determination of the time of contract formation when data messages were used for that purpose, the provision was not necessary, since the new text of draft article 8, paragraph 1, already expressly recognized the possibility of offer and acceptance being communicated by means of data messages.

120. Paragraph 2 should also be deleted, since both variants were felt to deal with matters of substantive contract law, which the draft convention should not affect. In particular, it was said, the draft convention should not attempt to provide a rule on the time of contract formation, in order to avoid the creation of a dual regime where different rules would govern the time of formation of an electronic commerce contract within the draft convention and the time of formation of other types of contract outside the purview of the draft convention.

121. Having considered the various views that were expressed, the Working Group agreed to delete draft article 13.

### **Article 14 [12]. Use of automated information systems for contract formation**

122. The text of the draft article was as follows:

“A contract may be formed by the interaction of an automated information system and a person or by the interaction of automated information systems, even if no person reviewed each of the individual actions carried out by such systems or the resulting agreement.”

123. The Working Group noted that the draft provision, which the Working Group, at its thirty-ninth session, had decided to retain in substance (see A/CN.9/509, para. 103), further developed a principle formulated in general terms in article 13, subparagraph 2 (b), of the UNCITRAL Model Law on Electronic Commerce.<sup>13</sup>

124. The Working Group generally agreed that the draft article removed possible doubts concerning the validity of contracts that resulted from the interaction of automated information systems. It was pointed out that a number of jurisdictions had found it necessary or at least useful to enact similar provisions in domestic legislation on electronic commerce.

125. It was pointed out that, although the draft article was inspired by article 13, subparagraph 2 (b), of the UNCITRAL Model Law on Electronic Commerce,<sup>13</sup> the two provisions were not identical in purpose. Article 13, subparagraph 2 (b), of the Model Law was concerned with the attribution of messages sent by an automated information system, whereas the draft article was in the nature of a non-discrimination rule. Regardless of that, however, the provision might not be needed, since it could be regarded as already being covered by draft article 8, paragraph 1. It would, instead, be preferable to complement the draft article with clear provisions on attribution similar to those contained in the Model Law.

126. The Working Group agreed that there was a difference between the draft article and the related provision on attribution of data messages in the Model Law, which was essentially concerned with individual data messages. The current draft, however, went a step further and expressly recognized that data messages exchanged by automated information systems could generate binding obligations even without human intervention or review of those obligations or the actions that led to their creation. That was an important clarification that should be retained in the draft convention. The substance of the draft article was not already covered by draft article 8, paragraph 1, since it dealt with a particular category of data messages.

127. There was some support for the possibility of expanding the draft article to include rules on attribution of data messages that made it clear that a contract resulting from the interaction of a computer with another computer or person was attributable to the person in whose name the contract was entered into. There were, however, strong objections to that suggestion in view of the difficulty of finding an acceptable solution for legal issues related to attribution of data messages, having regard to the wide variety of factual situations that would need to be taken into

account, as had been seen during the preparation of article 13 of the Model Law. The Working Group noted that there was no consensus on the need for including rules on attribution in the draft convention and decided that no such rules should be drafted. It was understood, however, that the Working Group might wish to revisit that decision at a later stage.

128. To the extent, however, that the current formulation of the draft article gave rise to doubts as to its purpose and effect, particularly as regards the meaning of the phrase “a contract may be formed”, which was felt to be unclear, it was agreed that the provision could be reformulated. One proposal to recast the draft article as a principle of non-discrimination was to replace it with a provision along the following lines:

“A contract formed by the interaction of an automated information system and a person, or by the interaction of automated information systems, shall not be denied validity or enforceability on the sole ground that no person reviewed each of the individual actions carried out by such systems or the resulting agreement.”

129. The Working Group agreed that the proposed new version provided a good basis for further deliberations on the matter and decided to substitute it for the current draft. It was agreed that the appropriate place for the new provision should be considered by the Working Group at a later stage.

### **Article 15 [16]. Availability of contract terms**

130. The text of the draft article was as follows:

“A party offering goods or services through an information system that is generally accessible to persons making use of information systems shall make the data message or messages which contain the contract terms available to the other party [for a reasonable period of time] in a way that allows for its or their storage and reproduction. [A data message is deemed not to be capable of being stored or reproduced if the originator inhibits the printing or storage of the data message or messages by the other party.]”

131. The Working Group noted that the draft article, which was based on article 10, paragraph 3, of Directive 2000/31/EC of the European Union, appeared in square brackets, as there was no consensus on the need for the provision within the Working Group (see A/CN.9/509, paras. 123-125).

132. The Working Group further noted that, if the provision was retained, the Working Group might need to consider whether the draft article should provide consequences for the failure by a party to make available to the other party the contract terms and also what would be the appropriate consequences for a party's failure to do so. It was pointed out that, in some legal systems, the consequences might be that a contractual term that had not been made available to the other party could not be enforced against it.

133. The view was expressed that draft article 15 should be deleted for the same reasons that had been mentioned in connection with draft article 11. It was stated that it was pointless to establish regulatory provisions in the draft instrument, in

particular if no sanction was created. In favour of deletion, it was also stated that draft article 15 would result in imposing rules that did not exist in the context of paper-based transactions, thus departing from the policy that the draft convention should not create a duality of regimes governing paper-based contracts on the one hand and electronic transactions on the other. Furthermore, the draft article was based on incorrect assumptions, such as that terms or conditions in electronic commerce always existed in electronic form only, or that contract terms were always under the control of the offeror, which might not be the case, for example when the parties used a negotiating platform provided by an intermediary. Lastly, the draft article embodied a rule clearly aimed at protecting consumers, which was not the concern of the draft convention.

134. The opposing view, however, was that, except for the second sentence, the general policy embodied in the draft article should be retained, since it addressed specifically an element that was particularly important in the context of electronic contracts. In particular when the parties negotiated through open networks, such as the Internet, there was a concrete risk that the parties would be requested to agree to certain terms and conditions displayed by a vendor, but might not have access to those terms and conditions at a later stage. That situation, which might also happen in negotiations between business entities or professional traders, was clearly unfavourable to the party accepting the contractual terms of the other party. The problem described did not have the same magnitude in the non-electronic environment, since, except for purely oral contracts, the parties would in most cases have access to a tangible record of the terms governing their contract. It was recognized, however, that further consideration might be needed in respect of the consequences of non-compliance with draft article 15.

135. Having considered the views that were expressed and noting the lack of consensus within the Working Group as to the desirability of having a rule along the lines of the draft article, the Working Group agreed that the matter needed to be considered further at a later stage. It was agreed that, for that purpose, the Secretariat should be requested to prepare a revised version of draft article 15, based on the above discussion, to be placed between square brackets for discussion at a future session. The Secretariat was further requested to include, also within square brackets, an alternative version of the draft article that followed the approach that the Working Group had agreed to use in connection with draft article 11 (see para. 102 above). Such an alternative would provide that nothing in the draft convention affected the application of any rule of law that might require a party that negotiated a contract through the exchange of data messages to make available to the other contracting party the data messages that contained the contractual terms in a particular manner, or relieved a party from the legal consequences of its failure to do so.

**B. Note by the Secretariat on legal aspects of electronic commerce:  
electronic contracting: provisions for a draft convention,  
working paper submitted to the Working Group  
on Electronic Commerce at its forty-second session  
(A/CN.9/WG.IV/WP.103) [Original: English]**

1. The Working Group began its deliberations on electronic contracting at its thirty-ninth session (New York, 11-15 March 2002), when it considered a note by the Secretariat on selected issues relating to electronic contracting (A/CN.9/WG.IV/WP.95). That note also contained an initial draft tentatively entitled "Preliminary draft convention on [international] contracts concluded or evidenced by data messages" (A/CN.9/WG.IV/WP.95, annex I).
2. At that time, the Working Group held a general exchange of views on the form and scope of the instrument, but agreed to postpone discussion on exclusions from the draft convention until it had had an opportunity to consider the provisions related to location of the parties and contract formation (see A/CN.9/509, paras. 18-40). The Working Group then took up articles 7 and 14, both of which dealt with issues related to the location of the parties (A/CN.9/509, paras. 41-65). After it had completed its initial review of those provisions, the Working Group proceeded to consider the provisions dealing with contract formation in articles 8-13 (A/CN.9/509, paras. 66-121). The Working Group concluded its deliberations on the draft convention at that session with a discussion of draft article 15 on availability of contract terms (A/CN.9/509, paras. 122-125). The Working Group agreed, at that time, that it should consider articles 2-4, dealing with the sphere of application of the draft convention and articles 5 (definitions) and 6 (interpretation), at its fortieth session (A/CN.9/509, para. 15).
3. The Working Group resumed its deliberations on the preliminary draft convention at its fortieth session (Vienna, 14-18 October 2002). The Working Group began its deliberations by a general discussion on the scope of the preliminary draft convention (A/CN.9/527, paras. 72-81). The Working Group proceeded to consider articles 2-4, dealing with the sphere of application of the draft convention and articles 5 (definitions) and 6 (interpretation) (A/CN.9/527, paras. 82-126).
4. The Secretariat prepared thereafter a revised version of the preliminary draft convention (A/CN.9/WG.IV/WP.100, annex). The Working Group, at its at its forty-first session (New York, 5-9 May 2003), reviewed articles 1-11 of the revised preliminary draft convention (see A/CN.9/528, paras. 26-151). The Secretariat was requested to prepare a revised version of the preliminary draft convention, for consideration at the Working Group's forty-second session (Vienna 17-21 November 2003).
5. The annex to this note contains the newly revised version of the preliminary draft convention, which reflects the deliberations and decisions of the Working Group at its previous sessions.



## ANNEX

**PRELIMINARY DRAFT CONVENTION<sup>1</sup> ON THE USE OF DATA MESSAGES IN  
[INTERNATIONAL TRADE] [THE CONTEXT OF INTERNATIONAL  
CONTRACTS]****CHAPTER I. SPHERE OF APPLICATION***Article 1. Scope of application*

1. This Convention applies to the use<sup>2</sup> of data messages [in connection with an existing or contemplated contract] [in the context of the formation or performance of contracts]<sup>3</sup> between parties whose places of business are in different States:

- (a) When the States are Contracting States;
- (b) When the rules of private international law lead to the application of the law of a Contracting State; or<sup>4</sup>
- (c) When the parties have agreed that it applies.<sup>5</sup>

2. The fact that the parties have their places of business in different States is to be disregarded whenever this fact does not appear either from the contract or

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<sup>1</sup> The form of a convention represents a working assumption only (A/CN.9/484, para. 124) and is without prejudice to a final decision by the Working Group as to the nature of the instrument.

<sup>2</sup> The last version of this article described the scope of application as follows: "This Convention applies to [any kind of information in the form of data messages that is used][the use of data messages] in the context of [transactions] [contracts] [...]." The Working Group regarded the choice between those options as being of a stylistic nature (see A/CN.9/528, para. 41). The Secretariat suggests the retention of the second phrase only, as the draft convention is only concerned with the legal recognition of the use of data messages in the context of contracts, unlike the UNCITRAL Model Law on Electronic Commerce, which deals with the legal value of information in the form of data messages, regardless of whether the information is actually "used" (for instance, under article 10 of the Model Law, which deals with record retention). The deletion of the word "transactions" follows a decision by the Working Group (A/CN.9/528, para. 40). This change has also been made in other provisions that previously referred to "transactions".

<sup>3</sup> The alternative words in square brackets are meant to bring the draft article closer in line with draft article 8.

<sup>4</sup> This paragraph reproduces a rule that is contained in the provisions on the sphere of application of other UNCITRAL instruments. There have been objections to this rule on the grounds that such an expansion in the convention's field of application would significantly reduce certainty at the time of contracting owing to its inherent ex post facto nature (A/CN.9/509, para. 38). At its forty-first session, the Working Group agreed to retain the subparagraph (A/CN.9/528, para. 42). If the draft paragraph is retained, the Working Group would still need to consider whether reservations to this rule should be permitted, as was suggested at its forty-second session (A/CN.9/528, para. 42). See also draft article X, paragraph 1.

<sup>5</sup> This possibility is provided, for instance, in article 1, paragraph 2 of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit. The Working Group postponed a decision on this subparagraph until it has considered the operative provisions of the draft convention (A/CN.9/528, paras. 43-44). The Working Group may wish to consider whether it should be possible for contracting States to exclude this provision through a declaration made pursuant to draft article X, paragraph 1.

from any dealings between the parties or from information disclosed by the parties at any time before or at the conclusion of the contract.

3. Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of this Convention.

*Article 2. Exclusions*<sup>6</sup>

This Convention does not apply to the use of data messages [in connection with the following contracts, whether existing or contemplated] [in the context of the formation or performance of the following contracts]:

(a) Contracts concluded for personal, family or household purposes [unless the party offering the goods or services, at any time before or at the conclusion of the contract, neither knew nor ought to have known that they were intended for any such use];<sup>7</sup>

[(b) Contracts for the grant of limited use of intellectual property rights];<sup>8</sup>

(c) [*Other exclusions that the Working Group may decide to add.*]<sup>9</sup> [Other matters identified by a Contracting State under a declaration made in accordance with article X].<sup>10</sup>

<sup>6</sup> The last version of this draft article contained two variants reflecting alternative approaches for the treatment of consumer contracts. Variant A excluded consumer contracts by using the same technique that is used in article 2, subparagraph (a) of the United Nations Sales Convention. Variant B deferred to domestic law on consumer protection issues, without excluding consumer transactions from the draft convention (see A/CN.9/527, para. 89; see also A/CN.9/528, paras. 51-54). The present version of the draft article retains only the former Variant A. The former Variant B has been incorporated into draft article 3, as its content is more akin to that article, in its current formulation.

<sup>7</sup> The last phrase is in square brackets, since there was some support at the Working Group's forty-first session to the suggestion that all the words after "household purposes" should be deleted (A/CN.9/528, para. 52).

<sup>8</sup> This exclusion is in square brackets as the Working Group has not yet reached an agreement on the matter (see A/CN.9/527, paras. 90-93 and A/CN.9/528, paras. 55-60).

<sup>9</sup> This draft article might contain additional exclusions, as may be decided by the Working Group. Annex II of the initial draft (A/CN.9/WG.IV/WP.95) reproduced, for illustrative purposes and without the intention of being exhaustive, exclusions typically found in domestic laws on electronic commerce. Additional exclusions that had been proposed at the Working Group's fortieth session and reiterated at its forty-first session related to certain existing financial services markets with well-established rules resulting from specific regulations, standard agreements and practices, system rules or otherwise. Those exclusions included payment systems, negotiable instruments, derivatives, swaps, repurchase agreements (repos), foreign exchange, securities and bond markets, while possibly including general procurement activities of banks and loan activities (A/CN.9/527, para. 95 and A/CN.9/528, para. 61). Additional exclusions proposed at the Working Group's forty-first session include "real estate transactions, as well as contracts involving courts or public authorities, family law and the law of succession" (A/CN.9/528, para. 63). The Working Group may wish to note, in this connection, that the Commission, at its thirty-sixth session, has decided to undertake work in the area of public procurement, including procurement by electronic means (A/58/17, paras. 225-230). This may render an open-ended exclusion of "contracts involving courts or public authorities" inappropriate.

<sup>10</sup> This phrase is an alternative formulation that would obviate the need for a common list of exclusions (A/CN.9/527, para. 96).

*Article 3. Matters not governed by this Convention*

This Convention does not affect or override<sup>11</sup> any rule of law relating to:

- [(a) The protection of consumers;]<sup>12</sup>
- (b) The validity of the contract or of any of its provisions or of any usage [except as otherwise provided in articles [...]];<sup>13</sup>
- (c) The rights and obligations of the parties arising out of the contract or of any of its provisions or of any usage;<sup>14</sup> or
- (d) The effect which the contract may have on the ownership of rights created or transferred by the contract.<sup>15</sup>

*Article 4. Party autonomy*

The parties may exclude the application of this Convention or derogate from or vary the effect of any of its provisions [except for the following: ...].<sup>16</sup>

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<sup>11</sup> This formulation has been used following a suggestion at the Working Group's forty-first session that the words previously used ("This Convention is not concerned with") were inaccurate (A/CN.9/528, para. 67).

<sup>12</sup> Draft subparagraph (a) appears within square brackets, as it represents in some respects an alternative to draft article 2, subparagraph (a) (see A/CN.9/528, para. 52). Under this rule, consumer transactions would not be automatically excluded from the scope of the draft convention, but its provisions would not supersede or affect rules on consumer protection.

<sup>13</sup> Draft subparagraph (b) is derived from article 4, subparagraph (a), of the United Nations Sales Convention. The Working Group may wish to consider the relationship between the general exclusions under the draft article and other provisions that, for instance, affirm the validity of data messages, such as draft articles 8, 9 and 13 (see A/CN.9/527, para. 103).

<sup>14</sup> The preliminary draft convention is not concerned with substantive issues arising out of the contract, which, for all other purposes, remains subject to its governing law (see A/CN.9/527, paras. 10-12).

<sup>15</sup> Draft subparagraph (d) is based, *mutatis mutandis*, on article 4, subparagraph (b), of the United Nations Sales Convention.

<sup>16</sup> The Working Group has yet to consider whether some limitation to the principle of party autonomy is appropriate or desirable in the context of the preliminary draft convention, in particular in the light of provisions such as draft articles 9, para. 3; 11 and 15 (see A/CN.9/527, para. 109; see also A/CN.9/528, paras. 71-75). The earlier version of this article contained a second paragraph dealing with parties' consent to the use of data messages in a contractual context. That provision has now been combined with draft article 8.

**CHAPTER II. GENERAL PROVISIONS***Article 5. Definitions*<sup>17</sup>

For the purposes of this Convention:

(a) “Data message” means information generated, sent, received or stored by electronic, optical or similar means including, but not limited to, electronic data interchange (EDI), electronic mail, telegram, telex or telecopy;

(b) “Electronic data interchange (EDI)” means the electronic transfer from computer to computer of information using an agreed standard to structure the information;

(c) “Originator” of a data message means a person by whom, or on whose behalf, the data message purports to<sup>18</sup> have been sent or generated prior to storage, if any, but it does not include a person acting as an intermediary with respect to that data message;

(d) “Addressee” of a data message means a person who is intended by the originator to receive the data message, but does not include a person acting as an intermediary with respect to that data message;

(e) “Information system” means a system for generating, sending, receiving, storing or otherwise processing data messages;<sup>19</sup>

(f) “Automated information system” means a computer program or an electronic or other automated means used to initiate an action or respond to data messages or performances in whole or in part, without review or intervention by a natural person each time an action is initiated or a response is generated by the system;<sup>20</sup>

[(g) “Electronic signature” means data in electronic form in, affixed to, or logically associated with, a data message, which may be used to identify the person holding the signature creation data in relation to the data message and indicate that person’s approval of the information contained in the data message;<sup>21</sup>

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<sup>17</sup> The definitions contained in draft paragraphs (a) to (e) are derived from article 2 of the UNCITRAL Model Law on Electronic Commerce. The definition of “electronic signature” corresponds to the definition of the same expression in article 2 of the UNCITRAL Model Law on Electronic Signatures. The definitions of “offeror” and “offeree” have been deleted, although the Working Group had tentatively retained them (A/CN.9/527, para. 115). The Secretariat submits that those words have become superfluous in view of the reformulation of draft articles 8 and 13 (see A/CN.9/528, para. 106).

<sup>18</sup> The wording of this definition is taken from article 2, subparagraph (c), of the UNCITRAL Model Law on Electronic Commerce. It has been suggested to the Secretariat that it might be preferable to delete the words “purports to have been” and use instead the words “has been sent”.

<sup>19</sup> The Working Group may wish to consider whether this definition needs further clarification, in view of the questions that have been raised in connection with paragraph 2 of the former article 11 (currently article 10) (see A/CN.9/528, paras. 148-149).

<sup>20</sup> This definition is based on the definition of “electronic agent” contained in section 2 (6) of the Uniform Electronic Transactions Act of the United States of America; a similar definition is also used in section 19 of the Uniform Electronic Commerce Act of Canada. This definition was included in view of the contents of draft article 14.

<sup>21</sup> The initial draft contained in document A/CN.9/WG.IV/WP.95 included, as a variant to this

[(h) “Place of business”<sup>22</sup> means [any place of operations where a person carries out a non-transitory activity with human means and goods or services;]<sup>23</sup> [the place where a party maintains a stable establishment to pursue an economic activity other than the temporary provision of goods or services out of a specific location;]<sup>24</sup>

[(i) “Person” and “party” include natural persons and legal entities;]<sup>25</sup>

[(j) Other definitions that the Working Group may wish to add.]<sup>26</sup>

#### *Article 6. Interpretation*

1. In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

2. Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on

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provision, a general definition of “signature”. Although the Working Group tentatively agreed on retaining both variants, the Secretariat suggests that it might be more appropriate, given the limited scope of the draft convention, to define only “electronic signatures”, leaving a definition of “signature” for the otherwise applicable law, as had been suggested at the Working Group’s fortieth session (A/CN.9/527, paras. 116-119).

<sup>22</sup> The proposed definition appears within square brackets since the Commission has not thus far defined “place of business” (see A/CN.9/527, paras. 120-122). At the Working Group’s thirty-ninth session, it was suggested that the rules on parties’ location should be expanded to include elements such as the place of an entity’s organization or incorporation (A/CN.9/509, para. 53). The Working Group decided that it could consider the desirability of using supplementary elements to the criteria used to define the parties’ location by expanding the definition of place of business (A/CN.9/509, para. 54). The Working Group may wish to consider whether the proposed additional notions and any other new elements should be provided as an alternative to the elements currently used or only as a default rule for those entities without an “establishment”. Additional cases that might deserve consideration by the Working Group might include situations where the most significant component of human means or goods or services used for a particular business are located in a place bearing little relationship to the centre of a company’s affairs, such as when the only equipment and personnel used by a so-called “virtual business” located in one country consists of leased space in a third-party server located elsewhere.

<sup>23</sup> This alternative reflects the essential elements of the notions of “place of business”, as understood in international commercial practice, and “establishment”, as used in article 2, subparagraph (f), of the UNCITRAL Model Law on Cross-Border Insolvency.

<sup>24</sup> This alternative follows the understanding of the concept of “place of business” in the European Union (see paragraph 19 of the preamble to Directive 2000/31/EC of the European Union).

<sup>25</sup> During the preparation of the UNCITRAL Model Law on Electronic Commerce, it was felt that such a definition did not belong in the text of the instrument, but in its guide to enactment. As a Convention would not normally be accompanied by extensive comments, the proposed definition has been included in the form of a provision, should the Working Group find such a definition necessary, particularly in view of provisions such as draft article 9, Variant B, subparagraph 4 (b).

<sup>26</sup> The Working Group may wish to consider whether definitions of other terms should be included, such as “signatory” (if variant B of draft article 10 (formerly 14) is adopted), “interactive applications”, “electronic mail” or “domain name”.

which it is based or, in the absence of such principles, in conformity with the law applicable [by virtue of the rules of private international law].<sup>27</sup>

*Article 7. Location of the parties*<sup>28</sup>

1. For the purposes of this Convention, a person's place of business is presumed to be the location indicated by that person [, unless the person does not have a place of business at such location [[and] that such indication is made solely to trigger or avoid the application of this Convention]].

2. If a person [has not indicated a place of business or, subject to paragraph 1 of this article, a person]<sup>29</sup> has more than one place of business, the place of business for the purposes of this Convention is that which has the closest relationship to the relevant contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract.

3. If a person does not have a place of business, reference is to be made to the person's habitual residence.

4. The place of location of the equipment and technology supporting an information system used by a person in connection with the formation of a contract or the place from which such information system may be accessed by other persons, in and of themselves, do not constitute a place of business [, unless such legal entity does not have a place of business [within the meaning of article 5 (h)]].<sup>30</sup>

<sup>27</sup> The closing phrase has been placed in square brackets at the request of the Working Group. Similar formulations in other instruments had been incorrectly understood as allowing immediate referral to the applicable law pursuant to the rules on conflict of laws of the forum State for the interpretation of a Convention without regard to the conflict of laws rules contained in the Convention itself (A/CN.9/527, paras. 125 and 126).

<sup>28</sup> Draft paragraph 1 builds upon a proposal made at the thirty-eighth session of the Working Group to the effect that the parties should have the duty to disclose their places of business (A/CN.9/484, para. 103). That duty is reflected in draft article 11, paragraph 1, subparagraph (b). The draft provision is not intended to create a new concept of "place of business" for the online world. The phrase in square brackets aims to prevent a party from benefiting from recklessly inaccurate or untruthful representations (A/CN.9/509, para. 49), but not to limit the parties' ability to choose the Convention or otherwise agree on the applicable law. The two variants previously contained in the draft paragraph have been combined as the Working Group preferred the former Variant A (A/CN.9/528, para. 88). The words "manifest and clear", which the Working Group found to be conducive to legal uncertainty (A/CN.9/528, para. 86), have been deleted.

<sup>29</sup> It has been suggested to the Secretariat that the presumption contemplated in the draft article could also apply in the event that a party does not indicate its place of business. This suggestion has been inserted in square brackets, since the presumption contemplated in the draft article has been used in other UNCITRAL instruments only in connection with multiple places of business.

<sup>30</sup> The draft paragraph reflects the principle that rules on location should not result in any given party being considered as having its place of business in one country when contracting electronically and in another country when contracting by more traditional means (A/CN.9/484, para. 103). The draft paragraph follows the solution proposed in paragraph 19 of the preamble to Directive 2000/31/EC of the European Union. The phrase within square brackets is intended to deal only with so-called "virtual companies" and not with natural persons, who are covered by the rule contained in draft paragraph 3. The Working Group may wish to consider whether draft paragraphs 4 and 5, which the Working Group agreed to retain for further consideration, should be combined in one provision (A/CN.9/509, para. 59).

5. The sole fact that a person makes use of a domain name or electronic mail address connected to a specific country does not create a presumption that its place of business is located in such country.<sup>31</sup>

### CHAPTER III. USE OF DATA MESSAGES IN INTERNATIONAL CONTRACTS<sup>32</sup>

#### *Article 8 [10]. Legal recognition of data messages<sup>33</sup>*

1. Any communication, declaration, demand, notice or request that the parties are required to make or choose to make [in connection with an existing or contemplated contract] [in the context of the formation or performance of a contract]<sup>34</sup> [, including an offer and the acceptance of an offer,]<sup>35</sup> may be conveyed by means of data messages and shall not be denied validity or enforceability on the sole ground that data messages were used for that purpose.

[2. Nothing in this Convention requires a person to use or accept information in the form of data messages, but a person's consent to do so may be inferred from the person's conduct.]<sup>36</sup>

[3. The provisions of this article do not apply to the following: [...] [The provisions of this article do not apply to those matters identified by a Contracting State under a declaration made in accordance with article X.]<sup>37</sup>

<sup>31</sup> The current system for assignment of domain names was not originally conceived in geographical terms. Therefore, the apparent connection between a domain name and a country is often insufficient to conclude that there is a genuine and permanent link between the domain name user and the country (A/CN.9/509, paras. 44-46). However, in some countries the assignment of domain names is only made after verification of the accuracy of the information provided by the applicant, including its location in the country to which the relevant domain name relates. For those countries, it might be appropriate to rely, at least in part, on domain names for the purpose of article 7, contrary to what was suggested in the draft paragraph (A/CN.9/509, para. 58). The Working Group may wish to consider whether the proposed rules should be expanded to deal with those situations.

<sup>32</sup> This chapter has been restructured. The numbers in square brackets after the article numbers indicate the corresponding numbers in the previous version of the draft convention (A/CN.9/WG.IV/WP.100).

<sup>33</sup> Paragraphs 1 and 2 have been combined to avoid unnecessary repetition. The phrase "unless otherwise agreed by the parties" has been deleted, as it was done elsewhere in the text (see A/CN.9/528, paras. 97-1100 and 126).

<sup>34</sup> The reference to "existing or contemplated contract" has been added pursuant to a suggestion by the Working Group (A/CN.9/528, para. 125). These words, and the alternative reference to "the formation and performance of a contract" have also been used elsewhere.

<sup>35</sup> The reference to "offer and acceptance" in square brackets is intended to facilitate a consideration by the Working Group as to whether the substance of draft articles 8 and 13 could be usefully combined (see A/CN.9/528, para. 105).

<sup>36</sup> The provision reflects the idea that parties should not be forced to accept contractual offers or acts of acceptance by electronic means if they do not want to do so (A/CN.9/527, para. 108). This paragraph was originally contained in draft article 4 (see footnote 15).

<sup>37</sup> Since the draft convention now covers all electronic communications and not only contract formation, the Working Group may wish to consider whether additional specific exclusions would be needed. There were expressions of support for developing a common list of exclusions, in the interest of ensuring a high degree of uniformity in the application of the convention, but there were also expressions of doubt as to the feasibility of developing such a list. The Working Group agreed to keep both options in the text and to revert to the matter later (A/CN.9/528, para. 131).

*Article 9 [14]. Form requirements*

[1. Nothing in this Convention requires a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make [in connection with an existing or contemplated contract] [in the context of the formation or performance of a contract]<sup>38</sup> to be made or evidenced in [a particular form, including written form] [by data messages, writing or any other form] or subjects a contract to any other requirement as to form.]<sup>39</sup>

2. Where the law requires that a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make in connection with a contract should be in writing, that requirement is met by a data message if the information contained therein is accessible so as to be usable for subsequent reference.<sup>40</sup>

3. Where the law requires that a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make in connection with a contract should be signed, or provides consequences for the absence of a signature, that requirement is met in relation to a data message if:

Variant A<sup>41</sup>

(a) A method is used to identify that person and to indicate that person's approval of the information contained in the data message; and

(b) That method is as reliable as appropriate to the purpose for which the data message was generated or communicated, in the light of all the circumstances, including any relevant agreement.

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<sup>38</sup> The qualification "falling within the scope of this Convention" has been deleted in the draft paragraph and elsewhere, so as to avoid possible conflicts between the field of application of the draft convention and the field of application of other conventions, to which draft article Y refers.

<sup>39</sup> This provision incorporates the general principle of freedom of form contained in article 11 of the United Nations Sales Convention, in the manner suggested at the Working Group's thirty-ninth session (A/CN.9/509, para. 115).

<sup>40</sup> This provision sets forth the criteria for the functional equivalence between data messages and paper documents, in the same manner as article 6 of the UNCITRAL Model Law on Electronic Commerce. The Working Group may wish to consider the meaning of the words "the law" and "writing" and whether there would be a need for including definitions of those terms (see A/CN.9/509, paras. 116 and 117).

<sup>41</sup> Variant A recites the general criteria for the functional equivalence between hand-written signatures and electronic identification methods referred to in article 7 of the UNCITRAL Model Law on Electronic Commerce.



Variant B<sup>42</sup>

... an electronic signature is used which is as reliable as appropriate to the purpose for which the data message was generated or communicated, in the light of all the circumstances, including any relevant agreement.

4. An electronic signature is considered to be reliable for the purposes of satisfying the requirements referred to in paragraph 3 of this article if:

(a) The signature creation data are, within the context in which they are used, linked to the signatory and to no other person;

(b) The signature creation data were, at the time of signing, under the control of the signatory and of no other person;

(c) Any alteration to the electronic signature, made after the time of signing, is detectable; and

(d) Where the purpose of the legal requirement for a signature is to provide assurances as to the integrity of the information to which it relates, any alteration made to that information after the time of signing is detectable.

5. Paragraph 4 of this article does not limit the ability of any person:

(a) To establish in any other way, for the purposes of satisfying the requirement referred to in paragraph 3 of this article, the reliability of an electronic signature;

(b) To adduce evidence of the non-reliability of an electronic signature.

*Article 10 [11]. Time and place of dispatch and receipt of data messages<sup>43</sup>*

1. The time of dispatch of a data message is deemed to be the time when the data message enters an information system outside the control of the originator or of the person who sent the data message on behalf of the originator.

2. The time of receipt of a data message is determined as follows:

(a) If the addressee has designated an information system for the purpose of receiving data messages, the data message is deemed to be received at the time when it enters the designated information system;

(b) If the addressee has designated an information system for the receipt of the data message, but the data message is sent to another information system of the addressee, the data message is deemed to be received at the time when it is retrieved by the addressee;

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<sup>42</sup> Variant B is based on article 6, paragraph 3, of the draft UNCITRAL Model Law on Electronic Signatures. The Working Group may wish to consider the need for a definition of “person” (currently provided in subparagraph (i) of draft article 5) in view of the fact that authentication and signature devices may be issued to the holder of particular functions within a corporation or other type of legal entity.

<sup>43</sup> Except for draft paragraph 4, the rules contained in this draft article are based on article 15 of the UNCITRAL Model Law on Electronic Commerce, with some adjustments to harmonize the style of the individual provisions with the style used elsewhere in the draft convention. Both paragraphs 1 and 2 have been redrafted, as their previous formulation was felt to be unclear (A/CN.9/528, paras. 140 and 148-149).

(c) If the addressee has not designated an information system, the message is deemed to be received at the time when the data message enters an information system of the addressee unless ...<sup>44</sup>

[Variant A

... it was unreasonable for the originator to have chosen that particular information system for sending the data message, having regard to the circumstances of the case and the content of the data message.] [or]

[Variant B

... the addressee could not reasonably expect that the data message would be addressed to that particular information system.]

3. Paragraph 2 of this article applies notwithstanding that the place where the information system is located may be different from the place where the data message is deemed to be received under paragraph 5 of this article.

4. When the originator and the addressee use the same information system, both the dispatch and the receipt of a data message occur when the data message becomes capable of being retrieved and processed by the addressee.<sup>45</sup>

5. A data message is deemed to be dispatched at the place where the originator has its place of business and is deemed to be received at the place where the addressee has its place of business, as determined in accordance with article 7.

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<sup>44</sup> The alternative words in square brackets in subparagraph (c) reflect proposals made at the Working Group's forty-first session (A/CN.9/528, paras. 146-147). The Secretariat submits that those sets of words are not necessarily mutually exclusive, and has combined them with the conjunction "or".

<sup>45</sup> This draft paragraph deals with cases where both the originator and the addressee use the same information system. In such a case, the criterion used in draft paragraph 1 cannot be used, since the message remains in a system that cannot be said to be "outside the control of the originator". The rule proposed in the draft paragraph treats dispatch and receipt of a data message as being simultaneous when the message "becomes capable of being retrieved and processed by the addressee". This situation was not contemplated by article 15, paragraph 1, of the Model Law. It is submitted, however, that the proposed special rule, which is inspired by section 23 (1) (a) of the Uniform Electronic Commerce Act of Canada, does not conflict with the rules contained in article 15 of the Model Law. The Working Group may wish to consider whether mutual use of the world wide web, a web site or specific web page for communication purposes should be considered as "use of the same information system."

[Article 11 [15]. General information to be provided by the parties<sup>46</sup>

Data messages used for the advertisement or offer of goods or services<sup>47</sup> shall include the following information:<sup>48</sup>

(a) The name of the party on whose behalf the advertisement or offer is made and, for legal entities, its full corporate name and place of registration, organization or incorporation;<sup>49</sup>

(b) The geographic location and address at which that party has its place of business, including its electronic mail address and other contact details.<sup>50</sup>

Article 12 [9]. Invitations to make offers<sup>51</sup>

Variant A

1. A proposal to conclude a contract made through one or more data messages which is not addressed to one or more specific persons, but is generally accessible to persons making use of information systems is to be regarded merely as an invitation to make offers, unless it indicates the intention of the person making the proposal to be bound in case of acceptance.<sup>52</sup>

<sup>46</sup> The draft article, which is inspired by article 5, paragraph 1, of Directive 2000/31/EC of the European Union, appears in square brackets, as there was no consensus on the need for the provision within the Working Group (A/CN.9/509, paras. 61-65). In its current form, the draft article does not contemplate any sanctions or consequences for a party's failure to provide the required information, a matter that still needs to be considered by the Working Group (see A/CN.9/509, para. 123, and A/CN.9/527, para. 103). The draft article would only apply to data messages related to contracts that are not excluded from the scope of application of the draft convention under article 2.

<sup>47</sup> The previous version of the draft article used the phrase "a person that uses data messages to advertise or offer goods or services [...]." The Working Group may wish to consider whether a formulation that focuses on the data message and its contents, rather than on an obligation imposed upon a person might help address the concerns that have been expressed regarding the apparently regulatory nature of the provision (A/CN.9/509, para. 63). The second paragraph of the earlier version, which provided that the information required by paragraph 1 should be "easily, directly and permanently accessible" has been deleted, as direct accessibility is implied by the new formulation of the draft article.

<sup>48</sup> The Working Group may wish to consider the desirability of specifying in the provision how the information is to be made "available", for instance, whether it must be contained in the data message or messages offering goods or services or by appropriate reference therein, in particular whether the information also needs to be capable of being retrieved or stored by the addressee.

<sup>49</sup> The reference to trade registers and registration numbers has been replaced with a more general reference to the corporate name and place of registration, organization or incorporation.

<sup>50</sup> The former subparagraphs (b) and (c) of the draft provisions have been combined for ease of reading.

<sup>51</sup> This provision deals with an issue that has given rise to extensive debate. At the Working Group's forty-first session, it was noted that "there was currently no standard business practice in that area" (A/CN.9/528, para. 117). Accordingly, the two variants represent the two different business practices that exist. Although both variants are meant as default rules in the absence of a clear indication of a person's intention, their appropriateness in the draft convention has been questioned (A/CN.9/528, paras. 117-118).

<sup>52</sup> This provision is inspired by article 14, paragraph 1, of the United Nations Sales Convention, and results from an analogy between offers made by electronic means and offers made through more traditional means (see A/CN.9/509, paras. 76-85). The Working Group may wish to

2. Unless otherwise indicated by the person making the proposal, a proposal to conclude a contract that makes use of interactive applications for the [automatic] placement of orders through such information system,<sup>53</sup> is an offer and is presumed to indicate the intention of the offeror to be bound in case of acceptance.<sup>54</sup>

Variant B<sup>55</sup>

A proposal to conclude a contract made through one or more data messages which is not addressed to one or more specific persons, but is generally accessible to parties making use of information systems, including proposals that make use of interactive applications for the [automatic] placement of orders through such information system, is to be regarded as an invitation to make offers, unless it clearly indicates the intention of the person making the proposal to be bound in case of acceptance.

*Article 13 [8]. Use of data messages in contract formation*<sup>56</sup>

1. [An offer and the acceptance of an offer may be expressed by means of data messages.] Where data messages are used [in the formation of a contract] [to convey an offer or the acceptance of an offer], [that contract] [the resulting contract]

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consider, however, whether specific rules should be formulated to deal with offers of goods through Internet auction platforms and similar transactions, which in many legal systems have been regarded as binding offers to sell the goods to the highest bidder.

<sup>53</sup> The previous version of the draft article referred to the use of “automated information systems” or, as an alternative, to the use of “an interactive application that appears to allow for the contract to be concluded automatically.” At the Working Group’s thirty-ninth session, it was said that the party placing an order might have no means of ascertaining how the order would be processed and whether it was in fact dealing with “automated computer systems allowing the contract to be concluded automatically” or whether other actions, by human intervention or through the use of other equipment, might be required in order to effectively conclude a contract or process an order. The original formulation in the draft paragraph was further criticized because the reference to an application that allowed a contract “to be concluded automatically”, seemed to assume that a valid contract had been concluded, which was felt to be misleading in a context dealing with actions that might lead to contract formation (A/CN.9/509, para. 82). The draft article refers to applications for the “placement” of orders, rather than to applications for “processing” orders, because the provision focuses on the elements that are apparent to the person placing an order, rather than on the internal functioning of the mechanism being used. The Working Group may wish to consider whether the current formulation would achieve the degree of objectivity desired by the Working Group.

<sup>54</sup> The rule proposed in variant A is similar to the rule proposed in legal writings for the functioning of automatic vending machines (see A/CN.9/WG.IV/WP.95, para. 54).

<sup>55</sup> At the Working Group’s thirty-ninth session, it was pointed out that entities offering goods or services through a web site that used interactive applications enabling negotiation and immediate processing of purchase orders for goods or services frequently indicated in their web sites that they were not bound by those offers. If that already was the case in practice, it would be questionable for the Working Group to make a presumption in the opposite direction in the draft provision (A/CN.9/509, para. 82). Variant B, which combines paragraphs 1 and 2 in a single provision, reflects that proposition and treats offers of goods or services, even where an “automated information system” is used, as an invitation to make offers (A/CN.9/528, para. 119).

<sup>56</sup> The Working Group may wish to consider whether the draft article would retain its relevance if the Working Group were to combine its substance with draft article 8 (see A/CN.9/528, para. 105).

shall not be denied validity or enforceability on the sole ground that data messages were used for that purpose.<sup>57</sup>

Variant A

2. When conveyed in the form of a data message, an offer and the acceptance of an offer become effective when they are received by the addressee.<sup>58</sup>

Variant B

2. Where the law of a Contracting State attaches consequences to the moment in which an offer or an acceptance of an offer reaches the offeror or the offeree, and a data message is used to convey such offer or acceptance, the data message is deemed to reach the offeror or the offeree when it is received by the offeror or the offeree.<sup>59</sup>

*Article 14 [12]. Use of automated information systems for contract formation*<sup>60</sup>

A contract may be formed by the interaction of an automated information system and a person or by the interaction of automated information systems, even if no person reviewed each of the individual actions carried out by such systems or the resulting agreement.

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<sup>57</sup> Paragraphs 1 and 3 have been combined in order to align this provision with the new structure of draft article 8. The first sentence has been placed in square brackets, as its elements may be already covered by the additional language in square brackets in draft article 8, paragraph 1. The second sentence contains language in square brackets offering two drafting choices for the provision.

<sup>58</sup> The rule in this paragraph, which appeared in the former draft article 8, reflect the essence of the rules on contract formation contained, respectively, in articles 15, paragraph 1, and 18, paragraph 2, of the United Nations Sales Convention. The verb “reach”, which is used in the United Nations Sales Convention, has been replaced with the verb “receive” in the draft article so as to align it with draft article 10, which is based on article 15 of the UNCITRAL Model Law on Electronic Commerce. The Working Group may wish to consider whether this rule is indeed needed, in view of the substantive nature and the limited scope of the instrument.

<sup>59</sup> This alternative has been suggested at the Working Group’s forty-first session (see A/CN.9/528, paras. 105-106). The Working Group may wish to consider, however, whether a parallel provision should be added for the notion of “dispatch”, even though it is not the prevailing rule on contract formation under the United Nations Sales Convention, since it may be relevant for contracts not covered by that convention, depending on the applicable law.

<sup>60</sup> This draft provision, which the Working Group, at its thirty-ninth session, decided to retain in substance (A/CN.9/509, para. 103), develops further a principle formulated in general terms in article 13, paragraph 2, subparagraph (b) of the UNCITRAL Model Law on Electronic Commerce. The draft article does not deviate from the current understanding of legal effects of automated transactions that a contract resulting from the interaction of a computer with another computer or person is attributable to the person in whose name the contract is entered into (A/CN.9/484, para. 106).

[Article 15 [16]. Availability of contract terms<sup>61</sup>

A party offering goods or services through an information system that is generally accessible to persons making use of information systems<sup>62</sup> shall make the data message or messages which contain the contract terms<sup>63</sup> available to the other party [for a reasonable period of time] in a way that allows for its or their storage and reproduction. [A data message is deemed not to be capable of being stored or reproduced if the originator inhibits the printing or storage of the data message or messages by the other party.]<sup>64</sup>

Article 16 [13]. Error in electronic communications

Variant A<sup>65</sup>

[Unless otherwise [expressly] agreed by the parties,]<sup>66</sup> a contract concluded by a person that accesses an automated information system of another party has no legal effect and is not enforceable if the person made an error in a data message and:<sup>67</sup>

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- <sup>61</sup> The draft article, which is based on article 10, paragraph 3, of Directive 2000/31/EC of the European Union, appears in square brackets, as there was no consensus on the need for the provision within the Working Group (A/CN.9/509, paras. 123-125). If the provision is retained, the Working Group may wish to consider whether the draft article should provide consequences for the failure by a party to make available the contract terms, and which consequences would be appropriate. In some legal systems the consequences might be that a contractual term that has not been made available to the other party cannot be enforced against it.
- <sup>62</sup> The Working Group may wish to consider whether these words adequately describe the types of situations that the Working Group intends to address in the draft article.
- <sup>63</sup> The words “and general conditions” have been deleted as they appeared to be redundant. The Working Group may however wish to consider whether the provision should be made more explicit as to the version of the contract terms that needs to be retained.
- <sup>64</sup> The Working Group may wish to consider whether this sentence is sufficiently flexible to allow for the creation of “original” or “unique” electronic records, which a party might have a legitimate interest in rendering incapable of replication (A/CN.9/509, para. 124).
- <sup>65</sup> This draft paragraph deals with the issue of errors in automated transactions (see A/CN.9/WG.IV/WP.95, paras. 74-79). Earlier versions of the draft article contained, in paragraph 1 of Variant A, a rule based on article 11, paragraph 2, of Directive 2000/31/EC of the European Union, which creates an obligation for persons offering goods or services through automated information systems to offer means for correcting input errors, and required such means to be “appropriate, effective and accessible”. The draft article was the subject of essentially two types of objections: one objection was that the draft convention should not deal with a complex substantive issue such as error and mistake, a matter on which the Working Group has not yet reached a final decision; another objection was that the obligations contemplated in article 14, paragraph 2, of the first version of the draft convention (as contained in A/CN.9/WG.IV/WP.95) were regarded as being of a regulatory or public law nature (A/CN.9/509, para. 108). The Working Group may wish to consider whether the latter objection could be addressed by deleting the reference to an obligation to provide means for correcting errors and by contemplating only private law consequences for the absence of such means.
- <sup>66</sup> The Working Group may wish to consider whether the possibility of derogation by agreement needs to be expressly made or can result from tacit agreement, for instance, when a party proceeds to place an order through the seller’s automated information system even though it is apparent to such party that the system does not provide an opportunity to correct input errors.
- <sup>67</sup> This provision deals with the legal effects of errors made by a natural person communicating with an automated information system. The draft provision is inspired by section 22 of the Uniform Electronic Commerce Act of Canada. At the Working Group’s thirty-ninth session it was suggested

(a) The automated information system did not provide the person with an opportunity to prevent or correct the error;

(b) The person notifies the other party of the error as soon as practicable when the person making the error learns of it and indicates that he or she made an error in the data message;

[(c) The person takes reasonable steps, including steps that conform to the other party's instructions, to return the goods or services received, if any, as a result of the error or, if instructed to do so, to destroy such goods or services; and

[(d) The person has not used or received any material benefit or value from the goods or services, if any, received from the other party.]<sup>68</sup>

#### Variant B

1. [Unless otherwise [expressly] agreed by the parties,]<sup>69</sup> a contract concluded by a person that accesses an automated information system of another party has no legal effect and is not enforceable if the person made an error in a data message and the automated information system did not provide the person with an opportunity to prevent or correct the error. The person invoking the error must notify the other party of the error as soon as practicable and indicate that he or she made an error in the data message.<sup>70</sup>

[2. A person is not entitled to invoke an error under paragraph 1:

(a) If the person fails to take reasonable steps, including steps that conform to the other party's instructions, to return the goods or services received, if any, as a result of the error or, if instructed to do so, to destroy such goods or services; or

(b) If the person has used or received any material benefit or value from the goods or services, if any, received from the other party.]<sup>71</sup>

[*Other substantive provisions that the Working Group may wish to include.*]<sup>72</sup>

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that such provisions might not be appropriate in the context of commercial (that is, non-consumer) transactions, since the right to repudiate a contract in case of material error may not always be provided under general contract law. The Working Group nevertheless decided to retain it for further consideration (A/CN.9/509, paras. 110 and 111).

<sup>68</sup> Subparagraphs (c) and (d) appear within square brackets since it was suggested, at the Working Group's thirty-ninth session, that the matters dealt with therein went beyond matters of contract formation and departed from the consequences of avoidance of contracts under some legal systems (A/CN.9/509, para. 110).

<sup>69</sup> See note 66.

<sup>70</sup> This variant combines in two paragraphs the various elements contained in paragraphs 2 and 3 and subparagraphs (a)-(d) of the first version of the draft article (A/CN.9/WG.IV/WP.95), as was requested by the Working Group (A/CN.9/509, para. 111).

<sup>71</sup> See footnote 68.

<sup>72</sup> Such additional provisions might include, beyond consequences for a person's failure to comply with draft articles 11, 15 and 16, an issue that the Working Group has not yet considered (A/CN.9/527, para.103), other issues dealt with in electronic commerce legislation, such as liability of information services providers for loss or delay in the delivery of data messages.

## CHAPTER IV. FINAL PROVISIONS

*[Article X. Declarations on exclusions<sup>73</sup>*

1. Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will not be bound by subparagraph 1 (b) of article 1 of this Convention.]<sup>74</sup>

2. Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will not apply this Convention to the matters specified in its declaration.

3. Any declaration made pursuant to paragraphs 1 and 2 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.]

*Article Y. Communications exchanged under other international conventions<sup>75</sup>*

1. Except as otherwise stated in a declaration made in accordance with paragraph 2 of this article, a State party to this Convention [may declare at any time that it]<sup>76</sup> undertakes to apply the provisions of [article 7 and ] chapter III<sup>77</sup> of this Convention to the exchange [by means of data messages] of any communications, declarations, demands, notices or requests [, including an offer and acceptance of an offer,] that the parties are required to make or choose to make in connection with or under ...

<sup>73</sup> The Working Group has not yet concluded its deliberations on possible exclusions to the preliminary draft convention under draft article 2 (A/CN.9/527, paras. 83-98). The draft article has been added as a possible alternative, in the event that consensus was not achieved on possible exclusions to the preliminary draft convention.

<sup>74</sup> At its forty-first session, the Working Group agreed to consider, at a later stage, a provision allowing Contracting States to exclude the application of subparagraph (b) of article 1, paragraph 1, along the lines of article 95 of the United Nations Sales Convention (A/CN.9/528, para. 42).

<sup>75</sup> The draft article is intended to offer a possible common solution for some of the legal obstacles to electronic commerce under existing international instruments, which had been the object of a survey contained in an earlier note by the Secretariat (A/CN.9/WG.IV/WP.94). At the Working Group's fortieth session, there was general agreement to proceed in that manner, to the extent that the issues were common, which was the case at least with regard to most issues raised under the instruments listed in variant A (A/CN.9/527, paras. 33-48). Variant B, in turn, would make it possible for a Contracting State to extend the application of the new instrument to the use of data messages in the context of other international conventions, as the Contracting State sees fit. Both variants might even be combined (see footnote 78).

<sup>76</sup> The language in square brackets is intended to give more flexibility in the application of the draft article, since, without such clarification, the provision might be read to the effect that an undertaking pursuant to the draft article needed to be assumed upon signature, ratification or accession and could not be expanded at a later stage. If these words are retained, a provision along the lines, of paragraph 3 of draft article X may be needed also in draft article Y.

<sup>77</sup> The specific reference to the substantive provisions of the draft convention contained in chapter III is intended to avoid the impression that the provisions on the scope of application of the draft convention would affect the definition of the scope of application of other international conventions. The Working Group may wish to consider whether the provisions of draft article 7, to which reference is made in square brackets, are also suitable for subsidiary (interpretative) application in the context of other international conventions, or whether they might interfere with the existing interpretation of those conventions.



## Variant A

... any of the following international agreements or conventions to which the State is or may become a Contracting State:

Convention on the Limitation Period in the International Sale of Goods (New York, 14 June 1974) and Protocol thereto (Vienna, 11 April 1980)

United Nations Convention on Contracts for the International Sale of Goods (Vienna, 11 April 1980)

United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (Vienna, 17 April 1991)

United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 11 December 1995)

United Nations Convention on the Assignment of Receivables in International Trade (New York, 12 December 2001)

## Variant B

... any international agreement or convention on private commercial law matters to which the State is a Contracting State and which are identified in that State's declaration.]<sup>78</sup>

2. Any State may declare at any time that it will not apply this Convention [or any specific provision thereof] to international contracts falling within the scope of [any of the above conventions.] [one or more international agreements, treaties or conventions to which the State is a Contracting Party and which are identified in that State's declaration.]

3. Any declaration made pursuant to paragraph 2 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.

*[Customary and other final clauses that the Working Group may wish to include.]*

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<sup>78</sup> A third possibility might be to combine both variants so that the application of paragraph 1 to the listed conventions would be without prejudice to the right of a Contracting State to extend the application of the new instrument to the use of data messages in the context of other international conventions.

**C. Note by the Secretariat on legal aspects of electronic commerce:  
electronic contracting: background information, working paper submitted  
to the Working Group on Electronic Commerce at its forty-second session  
(A/CN.9/WG.IV/WP.104 and Add.1-4) [Original English]**

**A/CN.9/WG.IV/WP.104**

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## I. Introduction

1. The present note summarizes the research that has been conducted by the Secretariat on some of the main issues that have been discussed by Working Group IV (Electronic Commerce) in connection with its deliberations on a preliminary draft convention on electronic contracting.<sup>1</sup> Its purpose is to assist the Working Group in its deliberations at its forty-second session (Vienna, 17-21 October 2003).

2. The issues dealt with in this note relate essentially to the location of the parties. Additional background notes dealing with other issues, such as the qualification of the parties' intent, time of dispatch and receipt of data messages, authentication and

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<sup>1</sup> The first version of a preliminary draft convention on electronic contracting is contained in document A/CN.9/WG.IV/WP.95. The Working Group considered that text at its thirty-ninth (New York, 11-15 March 2002) and fortieth sessions (Vienna, 14-18 October 2002). The Working Group's deliberations are reflected in its reports on the work of those sessions (A/CN.9/509 and A/CN.9/527, respectively). A second version of the preliminary draft convention is contained in document A/CN.9/WG.IV/WP.100, which was considered by the Working Group at its forty-first session (New York, 5-9 May 2003). The Working Group's deliberations are reflected in its report on the work of that session (A/CN.9/528), at which the Working Group requested the Secretariat to prepare a revised version of the preliminary draft convention, for consideration at its forty-second session. That text is contained in document A/CN.9/WG.IV/WP.103.

attribution of data messages, use of automated information systems and the availability of contract terms and other information will be issued as separate documents.

## II. Issues related to location of the parties

3. One of the central concerns of the Working Group since its initial discussion of issues raised by electronic contracting has been the need to enhance legal certainty and predictability. This might be achieved by uniform rules that facilitated a determination, among other factors, of the international or domestic character of a contract and the place of its formation. The Working Group felt that it would be generally desirable to formulate uniform international provisions offering elements that allowed the parties to ascertain beforehand the location of their counterparts (A/CN.9/484, para.103).

4. The underlying concern in the Working Group's consideration of this issue has been that the increased use of electronic communications makes it all the more important for traders to ascertain reasonably quickly some key contractual issues such as whether a valid and enforceable contract has been concluded and which law governs it.

5. Most international commercial law conventions have their field of application circumscribed to "international" transactions. The solutions adopted at both the national and international levels for defining an "international" contract range from general criteria, such as the contract having "significant connections with more than one State" or relating "to international commerce", to more specific factors, such as the fact that the parties have their "places of business" or habitual residence in different countries.<sup>2</sup> If a party has more than one place of business, those instruments refer to the place that has the closest relationship to the contract and its performance.<sup>3</sup>

6. When the parties to a contract concluded electronically clearly indicate the location of their relevant place of business, that indication is to be taken into account as an important criterion, if not the most important one, in determining the

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<sup>2</sup> For example, United Nations Convention on Contracts for the International Sale of Goods ("United Nations Sales Convention") (United Nations, *Treaty Series*, vol. 1489, No. 25567, p. 3, also available from [www.uncitral.org/english/texts/sales/CISG.htm](http://www.uncitral.org/english/texts/sales/CISG.htm)), article 1, paragraph 1; Convention on the Limitation Period in the International Sale of Goods ("United Nations Limitation Convention") (United Nations, *Treaty Series*, vol. 1511, No. 26119, p. 1), article 2, subparagraph (a); and article 1, subparagraph (a), of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (*Official Records of the General Assembly, Fiftieth Session, Supplement No. 17* and corrigendum (A/50/640 and Corr.1, annex). See also UNIDROIT Convention on International Financial Leasing, article 3, subparagraph 1 (a) ([www.unidroit.org/english/conventions/c-leas.htm](http://www.unidroit.org/english/conventions/c-leas.htm)) and UNIDROIT Convention on International Factoring, article 2, subparagraph 1 (a) ([www.unidroit.org/english/conventions/c-fact.htm](http://www.unidroit.org/english/conventions/c-fact.htm)).

<sup>3</sup> E.g. United Nations Sales Convention, article 10 (a); United Nations Limitation Convention, article 2 (c); United Nations Guarantees and Stand-by Convention, article 4, paragraph 2 (a); UNIDROIT Convention on International Financial Leasing, article 3, paragraph 2; and UNIDROIT Convention on International Factoring, article 2, paragraph 2.

“international” character of a contract.<sup>4</sup> However, this rule is of little help if no such indication has been made.

7. Difficulties might also arise under domestic rules on conflicts of law, which often use notions commonly found in international conventions (for example, “place of business” or a place having the “closest connection with a contract or its performance”). Additional problems may also result from rules of private international law that refer to the place of conclusion of the contract as a connecting factor, since the location of the parties may not be evident from the electronic communications they exchange.

8. In view of the above, the Working Group has considered whether there exist circumstances from which the location of the relevant place of business can be inferred and which might be used to establish a legal presumption of a party’s location.

### A. Location of information systems

9. Even if transmission protocols of electronic communications do not usually indicate where the parties are located, they often include a number of other types of apparently objective information, such as Internet Protocol (IP) addresses,<sup>5</sup> domain names<sup>6</sup> or information pertaining to intermediary information systems. So the question arises as to what value, if any, could be attached to such information for the purpose of determining the physical location of the parties.

10. The preparatory studies carried out by the Secretariat in connection with the first version of the preliminary draft convention suggested that the location of the equipment and of its supporting technology might not be adequate factors for determining the location of the parties, since they did not provide sufficient indication as to the ultimate parties to the contract, might change over time and were often not known or not apparent to the parties during their communications (A/CN.9/WG.IV/WP.95, para. 42). It was also pointed out that the management and operation of an information system might be entirely outsourced or run by a third party. For example, a contract made on behalf of the seller might be automatically concluded with the buyer by the computer of the Internet service provider (ISP) that hosts the seller’s web site. Reliance on the location of equipment might thus lead to the undesirable result of linking a contract to a geographical location that, although related to the path followed by the electronic messages exchanged by the parties, bears perhaps little or no relationship to their actual location.<sup>7</sup> Another undesirable

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<sup>4</sup> For instance, under the United Nations Sales Convention.

<sup>5</sup> The Internet Protocol (IP) address is a 32-bit number (128 according to IP version 6) that identifies each sender or receiver of information that is sent in packets across the Internet.

<sup>6</sup> A domain name is a name assigned to a numerical IP functioning as part of a uniform resource locator (URL).

<sup>7</sup> The need to retain the same definitions that are used for off-line transactions is also mentioned in Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the internal market (*Official Journal of the European Communities* L 17, 17/07/2000 p. 0001 016), where it is stated that:

“The place at which a service provider is established should be determined in conformity with the case-law of the Court of Justice according to which the concept of establishment involves

result might be that a person's place of business, when negotiating a contract electronically, might end up being different from the same person's place of business when negotiating through other means.<sup>8</sup> The Working Group has generally endorsed this analysis (A/CN.9/509, paras. 50 and 57).

11. Nevertheless, it is conceivable that electronic commerce and the "new economy" may involve activities that are entirely or predominantly carried out through the use of information systems, without a fixed "establishment"<sup>9</sup> or without any connection to a physical location other than, for instance, the registration of its articles of incorporation at a given registry. It has been argued that it might not be reasonable to apply to those so-called "virtual companies" the same criteria traditionally used to determine a person's place of business. In other words: Is it appropriate to give legal significance to the location of the equipment and technology supporting the information system or the places from which such a system may be accessed in order to establish where such a "virtual company" has its place of business?

12. To date, the Working Group does not seem to be inclined to depart from established criteria linked to the notion of "place of business" (A/CN.9/509, paras. 51-54 and 56-59; see also A/CN.9/528, para. 93). However, a full discussion of "virtual places of business" has not yet taken place. In that connection, the Working Group may wish to take note of related work that has been done by other organizations.

13. The issue of location of entities offering goods and services through electronic means has been considered by the Organisation for Economic Cooperation and Development (OECD) in the context of its work on international aspects of taxation. On 22 December 2000, the OECD Committee on Fiscal Affairs adopted changes to the commentary on article 5 of the Model Tax Convention on Income and on Capital ("the OECD Model Tax Convention") to deal with the issue of the application of the definition of permanent establishment, as understood in the context of the Model Tax Convention, in connection with electronic commerce.<sup>10</sup>

14. The OECD Committee on Fiscal Affairs points out that, while a location where automated equipment is operated by an enterprise "may constitute a permanent establishment in the country where it is situated", a distinction needs to be made "between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software

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the actual pursuit of an economic activity through a fixed establishment for an indefinite period: [...] the place of establishment of a company providing services via an Internet website is not the place at which the technology supporting its website is located or the place at which its website is accessible but the place where it pursues its economic activity."

<sup>8</sup> The risks of establishing a dual regime for business, depending on the media being used, has been one of the main concerns expressed by the International Chamber of Commerce in connection with UNCITRAL's current work on electronic contracting (see A/CN.9/WG.IV/WP.96; see also A/CN.9/WG.IV/WP.101).

<sup>9</sup> Thibault Verbiest and Maxime Le Borne, "*Le fonds de commerce virtuel: une réalité juridique?*" (www.droit-technologie.org), 24 May 2002.

<sup>10</sup> Organisation for Economic Cooperation and Development, *Clarification on the application of the permanent establishment definition in e-commerce: changes to the commentary on the Model Tax Convention on Article 5* (available at [www.oecd.org/dataoecd/46/32/1923380.pdf](http://www.oecd.org/dataoecd/46/32/1923380.pdf), last visited on 3 September 2003).

which is used by, or stored on, that equipment”. According to that interpretation, an Internet web site, which is a combination of software and electronic data, “does not in itself constitute tangible property and therefore does not have a location that can constitute a ‘place of business’ as there is no ‘facility such as premises or, in certain instances, machinery or equipment’ [...] as far as the software and data constituting that web site is concerned”. On the other hand, the Committee on Fiscal Affairs points out that a “server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a ‘fixed place of business’ of the enterprise that operates that server”.<sup>11</sup>

15. The distinction between a web site and the server on which the web site is stored and used is justified on the following grounds:

“[...] the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise [...], even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of [article 5 of the Model Tax Convention]<sup>12</sup> are met.”

<sup>11</sup> Ibid., para. 42.2.

<sup>12</sup> Paragraphs 1, 2 and 4 of article 5 (“Permanent establishment”) of the Model Tax Convention reads as follows:

“1. For the purposes of this Convention, the term ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

“2. The term ‘permanent establishment’ includes especially:

“a) a place of management;  
 “b) a branch;  
 “c) an office;  
 “d) a factory;  
 “e) a workshop, and  
 “f) mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

“[...]

“4 Notwithstanding the preceding provisions of this Article, the term ‘permanent establishment’ shall be deemed not to include:

“a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;  
 “b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

16. For the purpose of distinguishing between a web site and the server on which it is stored, the OECD Committee on Fiscal Affairs stresses the importance of identifying the place of performance of the core functions of a business entity, as opposed to ancillary activities (e.g. provision of a communications link between suppliers and customers, advertising of goods or services, relaying information through a mirror server for security and efficiency purposes, gathering market data for the enterprise or supplying information). In that connection, the following clarification is provided:

“42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an ‘e-tailer’) that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), [...] the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.”

17. The above clarification shows the narrow conditions under which a server may be regarded as a permanent establishment for taxation purposes. While the term “place of business”, as generally defined in private law may not necessarily coincide with the notion of “establishment” under domestic and international tax law, the Working Group may nevertheless wish to consider the extent to which the clarification provided by the OECD Committee on Fiscal Affairs offers elements that might be used in connection with article 7 of the preliminary draft convention.

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- “c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
  - “d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
  - “e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
  - “f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

“[...]”

## B. Domain names and electronic addresses

18. Another related question is the extent to which the address from which the electronic messages were sent could be taken into account to determine a party's location, so that in the case of addresses linked to domain names connected to specific countries (such as addresses ending with ".at" for Austria, ".nz" for New Zealand, etc.) the party could be presumed to have its place of business in the corresponding country.

19. In the course of the Working Group's deliberations, it was stated that, in some countries, the assignment of domain names was only made after verification of the accuracy of the information provided by the applicant, including its location in the country to which the relevant domain name related. For those countries, it might be appropriate to rely, at least in part, on domain names for ascertaining a party's location (A/CN.9/509, para. 58). However, in countries where no such verification takes place, an electronic mail (e-mail) address or a domain name could not automatically be regarded as the functional equivalent of the physical location of a party's place of business.<sup>13</sup> Moreover, in certain branches of business it is common for companies to offer goods or services through various regional web sites bearing domain names linked to countries where such companies do not have a "place of business" in the traditional sense of the term. Furthermore, goods being ordered from any such web site might be delivered from warehouses maintained for the purpose of supplying a particular region, which might be physically located in a country other than those linked to the domain names involved.

20. The Working Group may wish to explore further the possible role that domain names and e-mail addresses may play in establishing presumptions of a party's location and how such a presumption should be formulated so as to take into account the various domestic systems and practices for the assignment of domain names. One particular situation that the Working Group may need to bear in mind relates to the use of "generic" top-level domains<sup>14</sup> such as ".com" or ".net". Those types of domain name and e-mail address do not show any link to a particular country, which is possible because the system of assigning domain names for Internet sites has not been conceived in strictly geographical terms.

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<sup>13</sup> According to the Internet Corporation for Assigned Names and Numbers (ICANN), the assignment of top-level domain (TLDs) names including a country code (ccTLDs) is "delegated to designated managers, who operate the ccTLDs according to local policies that are adapted to best meet the economic, cultural, linguistic, and legal circumstances of the country or territory involved" ([www.icann.org/tlds/](http://www.icann.org/tlds/)). Needless to say, each country develops its own detailed rules for assigning domain names within its jurisdiction. The Swedish domain name registration system, for instance, seems to require proof of a company's claim to the domain name and its link to the country, whereas more "liberal" systems, such as that of Germany, only require the existence of a "contact person" in the country (see Frederik Roos, " 'First come, not served': domain name regulation in Sweden", *International Review of Law Computers and Technology*, vol. 17, No. 1, p. 70).

<sup>14</sup> "Generic" TLDs are registered directly through ICANN-accredited registrars (for further information on the system, see [www.iana.org/cctld/cctld.htm](http://www.iana.org/cctld/cctld.htm)).



### C. A duty to disclose the place of business?

21. The above discussion has shown that peripheral information related to electronic messages, such as an IP address, domain names or the geographical location of information systems, may have limited value for determining the physical location of the parties.

22. One approach being considered by the Working Group is to require the parties to electronic transactions to clearly indicate the location of their relevant places of business, as currently contemplated in articles 7, paragraph 1, and 11, subparagraph 1 (b), of the preliminary draft convention. However, that proposition has raised a number of questions, such as the extent to which such a duty, which does not exist for international paper-based transactions, might result in a duality of legal regimes (see A/CN.9/509, para. 63). Another concern is what kind of legal consequences might be attached to the lack or inaccuracy of such information and how an international uniform instrument on electronic contracting could deal with that issue without unduly interfering with the underlying contract law (A/CN.9/509, paras. 44-50 and 62-65; A/CN.9/528, paras. 83-91).

23. The Working Group may wish to note that, although no similar disclosure obligation exists in the United Nations Sales Convention, a number of other instruments contain provisions that contemplate an obligation for a party to disclose its place of business. This is the case, for example of article 15, subparagraph 1 (c), of the United Nations Convention on the Transport of Goods by Sea (“the Hamburg Rules”)<sup>15</sup> and—at least implicitly—in article 4, paragraph 1, of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (General Assembly resolution 50/48, annex). While it is true that those provisions relate to the required content of particular documents that have to be issued under those Conventions, there seems to be no *prima facie* reason for excluding analogous rules in the context of the preliminary draft convention, inasmuch as its article 11 deals with information that has to accompany business transactions.

24. The possible consequences of failure by a party to comply with draft article 11 do not need to be the nullity or non-enforceability of the transaction, a solution that was said to be “undesirable and unreasonably intrusive” (A/CN.9/509, para. 63). Paragraph 3, article 15, of the Hamburg Rules, for example, clearly provides that the absence in the bill of lading of one or more required particulars “does not affect the legal character of the document as a bill of lading provided that it nevertheless meets the requirements”. Other types of consequence may still be provided for, with a view to giving a meaningful purpose to article 11 of the preliminary draft convention.

25. One possible type of consequence might be linked to the field of application of the draft convention. For example, a party that fails to disclose its place of business might be presumed to have agreed to subject the contract to the regime of the draft convention if the other party is located in a contracting State and the applicable law is the law of a contracting State. Of course, such a solution would only be effective

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<sup>15</sup> United Nations, *Treaty Series*, vol. 1695, No. 29215, p. 3.

if the convention could be made applicable by the agreement of the parties, even if they were not both located in contracting States, a possibility that the Working Group has not yet fully considered (A/CN.9/528, paras. 43 and 44).

26. Court decisions may offer alternative legal consequences that may be attached to a party's deliberate or inadvertent failure to disclose its place of business. In one recent case, a court in the United States upheld the service of process against a foreign company by electronic means on the grounds that the foreign company had structured its business in such a way that it could be contacted only via its e-mail address and had listed no easily discoverable street address.<sup>16</sup> Such a result may not be easily transposed to the context of an international commercial law instrument. Nevertheless, this line of jurisprudence provides an example of a type of legal consequence that the Working Group might wish to consider, namely a presumption of consent to the receipt of messages or legal notices through a particular information system for parties that do not otherwise disclose their places of business.

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<sup>16</sup> *Rio Properties, Inc. v. Rio International Interlink*, United States Court of Appeals for the Ninth Circuit, 17 January 2002 (284 F.3d 1007). This case involved various trademark infringement claims by an American company against a foreign Internet business entity. After failed attempts to serve the defendant by conventional means in the United States of America, the claimant brought an emergency motion to effectuate alternative service of process by e-mail, which had been identified as being the defendant's preferred means of communication. The district court granted the motion. The district court entered default judgement against the defendant for failing to comply with the court's discovery orders. The defendant appealed the sufficiency of the service of process, effected via e-mail and regular mail pursuant to Federal Rule of Civil Procedure 4(f)(3). This rule permits service in a place not within any judicial district of the United States "by ... means not prohibited by international agreement as may be directed by the court". The Court of Appeals concluded that not only was service of process by e-mail proper—that is, reasonably calculated to apprise the defendant of the pendency of the action and afford it an opportunity to respond—but, in this particular case, it was the method of service most likely to reach the defendant. The Court noted in that connection that the defendant "structured its business such that it could be contacted only via its e-mail address" and that it "listed no easily discoverable street address". Rather, on its web site and print media, the defendant "designated its e-mail address as its preferred contact information".

**Note by the Secretariat on legal aspects of electronic commerce:  
electronic contracting: background information, working paper submitted  
to the Working Group on Electronic Commerce at its forty-second session**

ADDENDUM

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### III. Issues related to the use of data messages in international contracts

1. The present chapter deals with two sets of general issues on contract formation through electronic means. Section A below discusses how traditional notions of offer and acceptance may be applied to contract negotiation through electronic means. Section B, which appears in a further addendum (A/CN.9/WG.IV/WP.104/Add.2), considers questions related to timing of communications, including receipt and dispatch of offer and acceptance.

#### A. Qualification of parties' intent: offers and invitations to make offers

2. Article 14, paragraph 1, of the United Nations Convention on Contracts for the International Sale of Goods ("the United Nations Sales Convention")<sup>1</sup> provides that a proposal for concluding a contract that is addressed to one or more specific persons constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance. Paragraph 2 of that article provides,

<sup>1</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567, p. 3 (also available at [www.uncitral.org/english/texts/sales/CISG.htm](http://www.uncitral.org/english/texts/sales/CISG.htm)).

however, that a proposal other than one that is addressed to one or more specific persons is to be considered merely as an invitation to make offers, unless the contrary is clearly indicated by the person making the proposal.

3. In a paper-based environment, advertisements in newspapers, on the radio and television and in catalogues, brochures and price lists are generally regarded as invitations to submit offers (according to some legal writers, even in cases where they are directed to a specific group of customers), since in those cases the intention to be bound is considered to be lacking.<sup>2</sup>

#### 1. “Offers” and “advertisements” in electronic commerce

4. If the United Nations Sales Convention’s notion of “offer” is transposed to an electronic environment, a company that advertises its goods or services on the Internet or through other open networks should be considered to be merely inviting those who access the site to make offers. Thus, an offer of goods or services through the Internet would not *prima facie* constitute a binding offer.<sup>3</sup>

5. The difficulty that may arise in this context is how to strike a balance between a trader’s possible intention (or lack thereof) of being bound by an offer, on the one hand, and the protection of relying parties acting in good faith, on the other. The Internet makes it possible to address specific information to a virtually unlimited number of persons and current technology permits contracts to be concluded nearly instantaneously, or at least creates the impression that a contract has been so concluded.

6. In legal literature, it has been suggested that the “invitation-to-treat” paradigm may not be suitable for uncritical transposition to an Internet environment. One possible criterion for distinguishing between a binding offer and an invitation to treat may be based on the nature of the applications used by the parties. Legal writings on electronic contracting have proposed a distinction between web sites offering goods or services through interactive applications and those which use non-interactive applications. If a web site only offers information about a company and its products and any contact with potential customers lies outside the electronic

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<sup>2</sup> John Honnold, *Uniform Law for International Sales under the 1980 United Nations Convention*, 2nd ed. (Kluwer, Deventer, 1991), pp. 195-196; Ernst von Caemmerer and Peter Schlechtriem, *Kommentar zum einheitlichen UN-Kaufrecht*, 2nd ed. (München, 1995), art. 14, Nos. 13-15, pp. 144-146; Peter Schlechtriem, *Commentary on the UN Convention on the International Sale of Goods (CISG)* (Clarendon Press, Oxford, 1998), art. 14, Nos. 13-15, pp. 111-112; Heinrich Honsell, ed., *Kommentar zum UN-Kaufrecht*, (Springer, Berlin/Heidelberg/New York, 1997), art. 14, Nos. 17-19, p. 121; Fritz Enderlein and Dietrich Maskow, *International Sales Law* (Oceana, New York/London/Rome, 1992), p. 83; Maria del Pilar Perales Viscasillas, *La formación del contrato de compraventa internacional de mercaderías* (Valencia, 1996), p. 289. A few commentators argue, however, that catalogue mailings addressed to named recipients might be regarded as binding offers, since such mailings could not be regarded as being to “non-specified persons” (Vicent Heuzé, *La vente internationale de marchandises* (L.G.D.J., Paris, 2000), No. 175, p. 156; see also Bernard Audit, *La vente internationale de marchandises* (L.G.D.J., Paris, 1990), No. 62, p. 58, and Jean Thieffry and Chantal Granier, *La vente internationale*, 2nd ed. (Centre français du commerce extérieur, Paris, 1992), p. 89).

<sup>3</sup> Jens Werner, “E-Commerce.CO.UK: local rules in a global net: online business transactions and the applicability of traditional English contract law rules”, *International Journal of Communications Law and Policy*, No. 6, winter 2000/2001, p. 5.

medium, there would be little difference from a conventional advertisement. However, an Internet web site that uses interactive applications may enable negotiation and immediate conclusion of a contract (in the case of virtual goods even immediate performance). Legal writings on electronic commerce have proposed that such interactive applications might be regarded as an offer “open for acceptance while stocks last”, as opposed to an “invitation to treat”.<sup>4</sup>

7. This proposition is at least at first sight consistent with legal thinking for traditional transactions. Indeed, the notion of offers to the public that are binding upon the offeror “while stocks last” is recognized also for international sales transactions.<sup>5</sup> However, the potentially unlimited reach of the Internet and the risk of errors in electronic communications, including in posting price and other product information on a web site, compounded by the use of automatic reply functions that do not provide an opportunity for review and correction of errors, seem to call for caution.<sup>6</sup>

## 2. The debate within the Working Group

8. Ultimately, this is a question of risk allocation: should the seller be bound by its “offer” because it created the impression of a binding offer and did not indicate otherwise? Alternatively, should the buyer bear the risk of possibly forfeiting other business opportunities as a result of its reliance on what appeared to be a binding offer?

9. Arguments in favour of attaching a default presumption of binding intention to the use of interactive applications have invoked the aim of enhancing legal certainty in international transactions. It has been said that parties acting upon offers of goods or services made through interactive contract applications might be led to assume that offers made through such systems were firm offers and that by placing an order they might be validly concluding a binding contract at that point in time. Those parties, it has been said, should be able to rely on such a reasonable assumption in view of the potentially significant economic consequences of contract frustration, in particular in connection with purchase orders for securities, commodities or other items with highly fluctuating prices. A default rule might help enhance transparency in trading practices by encouraging business entities to state clearly whether or not they accepted to be bound by acceptance of offers of goods or services or whether they were only extending invitations to make offers (A/CN.9/509, para. 81).

10. The countervailing view is that attaching a presumption of binding intention to the use of interactive contracting applications would be detrimental for sellers holding a limited stock of certain goods, if the seller were to be liable to fulfil all

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<sup>4</sup> Christoph Glatt, “Comparative issues in the formation of electronic contracts”, *International Journal of Law and Information Technology*, vol. 6, spring 1998, p. 50.

<sup>5</sup> Von Caemmerer and Peter Schlechtriem, op. cit., p. 144; del Pilar Perales Viscasillas, op. cit., p. 295 and the example of Spanish legislation given in footnote 41.

<sup>6</sup> Werner (op. cit., p. 5) highlights the practical importance of the distinction between invitations to treat and offers with the following example: “E-tailer Argos offered by mistake a Sony TV for £3.00 instead of £299.99. People who spotted the bargain placed numerous orders for TVs which would constitute an acceptance (and thus conclude a contract) if the webvertisement of Argos could be regarded as a genuine offer.”

purchase orders received from a potentially unlimited number of buyers. Also, it has been argued that this kind of rule could run counter to business practice, as companies offering goods or services on the Internet typically indicate on their web sites that they are not bound by those advertisements (A/CN.9/509, para. 82; see also A/CN.9/528, paras. 116 and 117).

### 3. Court decisions on particular cases

11. With a view of facilitating its consideration of the implications of a decision in one way or the other, the Working Group may wish to take note of principles that have been developed by national courts on this matter. Generally, recent court decisions in cases involving Internet offers of tangible goods seem to confirm this understanding.<sup>7</sup> However, other cases seem to indicate that certain types of business activity conducted via the Internet may need specific rules, as discussed below.

#### (a) “Click-wrap” agreements

12. One such line of jurisprudence comprises cases dealing with so-called “click-wrap” agreements in the United States of America. Most—if not all—of those cases have involved contracts with Internet service providers or online purchases of software or other digitalized information through web sites that allowed online download of software or immediate connection to a provider of Internet access services.<sup>8</sup> Users were typically presented with messages on their computer screens requiring that they manifest their assent to the terms of the licence agreement by clicking on an icon. The products could not be obtained or used unless and until the icon was clicked. The main issue in such cases has been the enforceability of contract terms purported to have been incorporated by reference and the conditions under which a consumer may be validly bound by such terms. While the cases have not directly dealt with the nature of the seller’s offer (i.e. whether it was a true offer or merely an invitation to treat), the reasoning used by the courts to deal with such cases implies a certain understanding of the nature of the communications from which a qualification of the “offers” may be inferred.

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<sup>7</sup> Amtsgericht Butzbach, Case No. 51 C 25/02 (71), 14 June 2002, *JurPC-Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 348/2002 ([www.jurpc.de/rechtspr/20020348.htm](http://www.jurpc.de/rechtspr/20020348.htm)); Oberlandesgericht Frankfurt, 20 November 2002, *JurPC-Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 91/2003 ([www.jurpc.de/rechtspr/20030091.htm](http://www.jurpc.de/rechtspr/20030091.htm)); Amtsgericht Westerburg, Case No. 21 C 26/03, 14 March 2003, *JurPC-Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 184/2003 ([www.jurpc.de/rechtspr/20030184.htm](http://www.jurpc.de/rechtspr/20030184.htm)); and Landgericht Köln, Case No. 9 S 289/02, 16 April 2003, *JurPC-Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 138/2003 ([www.jurpc.de/rechtspr/20030138.htm](http://www.jurpc.de/rechtspr/20030138.htm)) (all pages accessed on 9 September 2003).

<sup>8</sup> See *Lawrence Groff v. America Online, Inc.*, Superior Court of Rhode Island, 27 May 1998, LEXIS 46 (R.I. Super., 1998) ([legal.web.aol.com/decisions/dlither/groff.html](http://legal.web.aol.com/decisions/dlither/groff.html), accessed on 3 September 2003); *Hotmail Corp. v. Van\$ Money Pie*, United States District Court for the Northern District of California, 16 April 1998, U.S. Dist. LEXIS 10729 (U.S. Dist., 1998); *Steven J. Caspi, et al. v. The Microsoft Network, L.L.C., et al.*, Superior Court of New Jersey, Appellate Division, 2 July 1999 (New Jersey Superior Court Reports, vol. 323, p. 118); and *I. Lan Systems, Inc. v. Netscout Service Level Corp.*, United States District Court, District of Massachusetts, 2 January 2002 (Federal Supplement, 2nd series, vol. 183, p. 328).

13. Firstly, the courts that have thus far dealt with “click-wrap” cases, even those which have denied their enforceability—as a whole or only of some of their terms—against consumers,<sup>9</sup> have not questioned the seller’s intention to be bound by its Internet offer of a software or similar product. Furthermore, while some courts have questioned the effectiveness of clicking on an icon or “I agree” button for the purpose of indicating assent to the terms of the vendor’s software licence agreements, the courts have not required a subsequent act of the vendor as a condition for a contract to be concluded. Nor have the courts denied the existence of a contract on the ground that the consumer’s action represented a contract offer that needed to be accepted by the buyer. It is in fact implicit in the reasoning of the courts that—at least in theory—a valid contract could be formed once the consumer had validly indicated its intention to purchase the software. The courts have not regarded the customer as the actual offeror and have, albeit not expressly, clearly treated the web site offerings as a binding commitment on the vendor and not a mere invitation to treat.

14. It may be argued that the fact that the products or services being offered allowed for immediate delivery by the vendor or immediate enjoyment by the customer was a decisive factor for the court’s affirmation of contract formation through customer action without requiring subsequent “acceptance” by the vendor, even though no such mention is made by the courts in those cases. Nevertheless, the Working Group may wish to consider the extent to which other situations might be treated in an analogous manner.

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<sup>9</sup> For instance, *Specht v. Netscape Communications Corp.*, Federal Supplement, 2nd series, vol. 150, p. 585, affirmed in *Specht v. Netscape Communications Corporation and America Online, Inc.*, United States Court of Appeals for the Second Circuit, 1 October 2002, Federal Reporter, 3rd series, vol. 306, p. 17.

(b) *Internet auctions*

15. The second group of case law deals with Internet auctions and involves both business-to-consumer and business-to-business auctions. In an early case, a district court in Germany found that a person offering goods through an Internet auction platform had not made a binding offer, but had merely invited offers in respect of the goods during a set period of time.<sup>10</sup> That decision was later reversed by the court of appeal, which found that the display of goods for auction purposes through an Internet auction platform constituted more than an invitation to treat and should be regarded as a binding contractual offer.<sup>11</sup> Such an offer did not represent an open-ended commitment to accept an unlimited number of offers, as it was limited to the acceptance of the highest bid remaining at the end of the auction period. The electronic auction process allowed for sufficient determination of the price, so that all essential elements of a binding offer to conclude a sales contract were present.

16. That understanding has been followed by other German courts<sup>12</sup> and was also affirmed by the Federal Court (*Bundesgerichtshof*), which expressly affirmed the principle that an offer of goods for auction purposes through an Internet auction platform with the indication that the seller was committed to accepting the highest effective bid constituted a valid anticipatory acceptance of the highest bid and not only an invitation to treat.<sup>13</sup> A court of appeals in the United States reached essentially the same conclusion in a case involving the auction of a domain name through the Internet. The court held that a party's *ex post facto* characterization of the contents of its web site as a "mere advertisement" did not by itself exclude the binding nature of a commitment to sell a certain item to the person offering the highest bid within a set period.<sup>14</sup>

17. It is not suggested that such jurisprudence would entirely reverse the rule currently reflected in article 12, variant B, of the preliminary draft convention (A/CN.9/WG.IV/WP.103). Nevertheless, the Working Group may wish to consider whether variant B of draft article 12, if retained by the Working Group, might require additional clarification, so as not to disrupt the principles that have been developed by domestic courts.

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<sup>10</sup> Landgericht Münster, Case No. 4 O 424/99, 21 January 2000, *JurPC-Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 60/2000 ([www.jurpc.de/rechtspr/20000060.htm](http://www.jurpc.de/rechtspr/20000060.htm), accessed on 1 September 2003).

<sup>11</sup> Oberlandesgericht Hamm, Case No. 2 U 58/00, 14 December 2000, *JurPC-Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 255/2000 ([www.jurpc.de/rechtspr/20000255.htm](http://www.jurpc.de/rechtspr/20000255.htm), accessed on 1 September 2003).

<sup>12</sup> Amtsgericht Hanover, Case No. 501 C 1510/01, 7 September 2002, *JurPC-Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 299/2002 ([www.jurpc.de/rechtspr/20020299.htm](http://www.jurpc.de/rechtspr/20020299.htm), accessed on 1 September 2003).

<sup>13</sup> Bundesgerichtshof, Case No. VIII ZR 13/01, 7 November 2001, *JurPC-Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 255/2001 ([www.jurpc.de/rechtspr/20010255.htm](http://www.jurpc.de/rechtspr/20010255.htm), accessed on 1 September 2003).

<sup>14</sup> *Je Ho Lim v. The TV Corporation International*, (State) Court of Appeal of California, 24 June 2002, 99 Cal. App. 4th 684.



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ADDENDUM

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### **III. Issues related to the use of data messages in international contracts**

#### **B. Time of receipt and dispatch of data messages and contract formation**

1. In its present version, the preliminary draft convention is not limited to the formation of contracts by electronic means and deals more broadly with the use of data messages “in connection with an existing or contemplated contract” or “in the context of the formation or performance of contracts” (see A/CN.9/WG.IV/WP.103, annex, art. 1, para. 1). Accordingly, the rules on time of dispatch and receipt of data messages in article 10 of the preliminary draft convention are intended to apply to messages exchanged before or after the conclusion of a contract or even where no contract is eventually concluded.

2. When the parties deal through more traditional means, the effectiveness of the communications they exchange depends on various factors, including the time of their receipt or dispatch, as appropriate. Although some legal systems have general rules on the effectiveness of communications in a contractual context, in many legal systems general rules are derived from the specific rules that govern the effectiveness of offer and acceptance for purposes of contract formation. The essential question before the Working Group is how to formulate rules on time of receipt and dispatch of data messages that adequately transpose to the context of the preliminary draft convention the existing rules for other means of communication.

## 1. Rules on contract formation

3. Rules on contract formation often distinguish between “instantaneous” and “non-instantaneous” communications of offer and acceptance or between communications exchanged between parties present at the same place at the same time (*inter praesentes*) or communications exchanged at a distance (*inter absentes*). Typically, unless the parties engage in “instantaneous” communication or are negotiating face-to-face, a contract will be formed when an “offer” to conclude the contract has been expressly or tacitly “accepted” by the party or parties to whom it was addressed.

4. Leaving aside the possibility of contract formation through performance or other actions implying acceptance,<sup>1</sup> which usually involves a finding of facts, the controlling factor for contract formation where the communications are not “instantaneous” is the time when an acceptance of an offer becomes effective. There are currently four main theories for determining when an acceptance becomes effective under general contract law, although they are rarely applied in pure form or for all situations.<sup>2</sup>

5. Pursuant to the “declaration” theory,<sup>3</sup> a contract is formed when the offeree produces some external manifestation of its intent to accept the offer, even though this may not yet be known to the offeror. According to the “mailbox rule”, which is traditionally applied in most common law jurisdictions,<sup>4</sup> but also in some countries belonging to the civil law tradition,<sup>5</sup> acceptance of an offer is effective upon dispatch by the offeree (for example, by placing a letter in a mailbox). In turn, under the “reception” theory, which has been adopted in several civil law jurisdictions,<sup>6</sup> the acceptance becomes effective when it reaches the offeror. Lastly, the “information” theory requires knowledge of the acceptance for a contract to be formed.<sup>7</sup> Of all these theories, the “mailbox rule” and the reception theory are the most commonly applied for business transactions.

<sup>1</sup> See the commentary to article 2.6 of the *UNIDROIT Principles of International Commercial Contracts* (Unidroit, Rome, 1994).

<sup>2</sup> See the overview of the existing common law and civil law rules on contract formation in María del Pilar Perales Viscasillas, *La formación del contrato de compraventa internacional de mercaderías* (Valencia, 1996), pp. 178 ff.

<sup>3</sup> Which seems to be the general rule for contract formation in Switzerland, where the formation of a contract occurs “*lorsque les parties ont, réciproquement et d’une manière concordante, manifesté leur volonté*” (*Code des Obligations*, art. 1).

<sup>4</sup> The mailbox rule was first adopted by the King’s Bench in 1818 in order to avoid the need for successive confirmations of receipt as that might continue “ad infinitum” (see *Adams v. Lindsell*, England Law Reports, vol. 160, p. 250 (K.B. 1818)). Despite some criticism, the mailbox rule has been nearly unanimously adopted in common law jurisdictions (see the references in Paul Fasciano, “Internet electronic mail: a last bastion for the mailbox rule”, *Hofstra Law Review*, vol. 25, No. 3 (spring 1997), pp. 971-1003, footnote 20).

<sup>5</sup> For instance, Argentina (*Código Civil*, art. 1154) and Brazil (*Código Civil*, art. 434).

<sup>6</sup> Such as in Austria (*Allgemeines Bürgerliches Gesetzbuch (ABGB)*, art. 862) and Germany (*Bürgerliches Gesetzbuch (BGB)*, sect. 130).

<sup>7</sup> For instance, Spain (*Código Civil*, art. 1262) and Venezuela (*Código de Comercio*, art. 120, para. 1). The “information” theory is the general rule for contract formation in Italy, where the

6. In some legal systems, both theories may be invoked, according to the context.<sup>8</sup> The notion of “receipt” is sometimes understood not only as a question of *time* but also as a question of *form* or maybe even *content* of the communication of acceptance. Thus, for example, the rules of the German Civil Code<sup>9</sup> on the legal effectiveness of legally relevant communications or “declarations of will” upon their receipt have been understood by German doctrine and case law to the effect that a communication has not only to reach the addressee’s sphere of control but it also has to be in such a form as to ensure the possibility for the addressee to become aware of it.<sup>10</sup> The latter element has been further subdivided into various substantive requirements, such as, for example, accessibility of the language of the communication<sup>11</sup> or delivery within normal working hours.<sup>12</sup>

7. The United Nations Convention on Contracts for the International Sale of Goods (“the United Nations Sales Convention”)<sup>13</sup> adopted the “reception” theory as a general rule.<sup>14</sup> Under the Sales Convention, a contract is concluded “at the moment when an acceptance of an offer becomes effective”,<sup>15</sup> which happens when “the indication of assent reaches the offeror”.<sup>16</sup> For the purposes of the Convention’s provisions on contract formation, an offer, declaration of acceptance or any other indication of intent “reaches” the addressee “when it is made orally to him or delivered by any other means to him personally, to his place of business or

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contract is concluded when the offeror “has knowledge” of the acceptance by the offeree (*Codice Civile*, art. 1326). However, knowledge is presumed when the acceptance is received at the offeror’s address (*Codice Civile*, art. 1335), which in practice brings the Italian system closer to the “reception” theory.

<sup>8</sup> This seems to be the case in France, where the Commercial Chamber of the Cour de cassation, in a judgement of 7 January 1981, affirmed the dispatch theory, but commentators continue to maintain the validity of the receipt theory (*Revue trimestrielle de droit civil*, 1981, pp. 849-850, note by François Chabas).

<sup>9</sup> *BGB*, sect. 130 (1).

<sup>10</sup> Otto Palandt, *Bürgerliches Gesetzbuch*, 60th ed. (München, Beck, 2001), p. 103, No. 3 (commentary on sect. 130 by H. Heinrichs); and *Münchener Kommentar zum Bürgerlichen Gesetzbuch*, vol. 1, 3rd ed. (München, Beck’sche Verlagsbuchhandlung, 1993), p. 1055, No. 10 (commentary on sect. 130 by H. Förschler).

<sup>11</sup> Transposed to the context of the United Nations Sales Convention, this requirement has led to the conclusion, for example, that standard contract conditions could not be relied upon if they have been sent in a language different from the one used during the negotiations (Amtsgericht Kehl, 6 October 1995, available at <http://cisgw3.law.pace.edu/cases/951006g1.html>).

<sup>12</sup> See the authorities cited elsewhere (Palandt, *op. cit.*; and *Münchener Kommentar ...*, No. 12).

<sup>13</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567, but also the *UNIDROIT Principles of International Commercial Contracts*, as follows from the combined reading of articles 2.1 and 2.6, paragraph 2.

<sup>14</sup> However, “dispatch” is also relevant for the operation of a number of provisions of the Convention, such as articles 19, paragraph 2 (notice of objection to additional terms proposed by offeree); 20 (period of time for acceptance); and 21 (conditions for effectiveness of late acceptance).

<sup>15</sup> United Nations Sales Convention, art. 23.

<sup>16</sup> United Nations, Sales Convention, art. 18, para. 2.

mailing address or, if he does not have a place of business or mailing address, to his habitual residence".<sup>17</sup>

8. The notion of "receipt" has been understood by commentators to mean the time when the communication enters the "sphere of control" of the addressee. Up to that time, the originator of the communication (in case of acceptance, the offeree) must ensure that the communication reaches the addressee and that it arrives within the required time. Where the notion of "dispatch" is relevant, the crucial moment is when the communication leaves the sphere of control of the originator. From that moment on, the originator would be relieved of the risk of loss or delay in the communication, with which instead the addressee would be concerned.

9. Commentators of the United Nations Sales Convention have observed that the notion of "reach" in article 24 of the Convention was made dependent upon "external, easily provable facts" and was meant to relieve the originator of the "risk of defective communications of a declaration within the recipient's organizational sphere"; circumstances that indicated that the provisions of article 24—contrary to the strict rules followed in some domestic laws—should be interpreted to the effect that "they generally do not require an opportunity for the recipient to gain awareness of the declaration".<sup>18</sup> Other ways of applying the article, for example, by attempting to take "national public holidays and customary working hours" into consideration were said to "lead to problems and to legal uncertainty in a law governing international situations".<sup>19</sup>

## 2. Timing of dispatch and receipt of data messages

10. The above considerations are equally important for the formation of contracts through electronic communications. Indeed, despite some early suggestions that contract negotiation through electronic means, in particular in an electronic data interchange (EDI) environment, replicates the pattern of "face-to-face" or "instantaneous" communications,<sup>20</sup> the exchange of electronic messages, at least when electronic mail (e-mail) techniques are used, seems to be more analogous to exchange of postal correspondence.<sup>21</sup>

11. In any event, default rules on time and place of dispatch and receipt of data messages should supplement national rules on dispatch and receipt by transposing

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<sup>17</sup> United Nations, Sales Convention, art. 24.

<sup>18</sup> Peter Schlechtriem, *Commentary on the UN Convention on the International Sale of Goods* (CISG) (Oxford, Clarendon Press, 1998), art. 24, Nos. 13-14, pp. 167-168; see also Ernst von Caemmerer and Peter Schlechtriem, *Kommentar zum einheitlichen UN-Kaufrecht*, 2nd ed. (München, 1995), art. 24, Nos. 13-14, pp. 202-203.

<sup>19</sup> *Ibid.*

<sup>20</sup> For example, Michael S. Baum and Henry H. Perritt, Jr., *Electronic Contracting, Publishing and EDI Law* (New York, Wiley Law Publications, 1991), p. 323, No. 6.8. The authors, however, recognize various factual circumstances that might lead to a different conclusion, such as "a certain non-instantaneous characteristic of computerized offers and acceptances, regardless of whether mailboxes or store-and-forward techniques are used in the transmission".

<sup>21</sup> "Despite common belief, [the transmission of Internet electronic mail] does not take place in a substantially instantaneous manner. Rather, it will typically take minutes, hours or in some cases days" (Fasciano, *loc. cit.*, pp. 1000-1001).

them to an electronic environment. Such provisions should be sufficiently flexible to cover both cases where electronic communication appears to be instantaneous and those where electronic messaging mirrors traditional mail. The following paragraphs analyse the way this has been done by the UNCITRAL Model Law on Electronic Commerce and in domestic legislation. They also summarize the debate that has taken place in the Working Group and offer elements that the Working Group may wish to consider in its deliberations on article 10 of the preliminary draft convention.

(a) *The rule in article 15 of the UNCITRAL Model Law on Electronic Commerce*

12. Article 15, paragraph 1, of the Model Law defines the time of *dispatch* of a data message as the time when the data message enters an “information system”<sup>22</sup> placed “outside the control of the originator”,<sup>23</sup> which may be the information system of an intermediary or an information system of the addressee. Under that provision, a data message should not be considered to have been dispatched if it merely reached the information system of the addressee but failed to enter it.<sup>24</sup>

13. For the time of *receipt*, paragraph 2 of the same article distinguishes between a few factual situations: (a) where the addressee designates a specific information system, which may or may not be his own, for the receipt of a message, the data message is deemed to have been received when it *enters the designated system*;<sup>25</sup> (b) if the data message is sent to an information system of the addressee that is not the designated system, “receipt” occurs when the data message is *retrieved by the addressee*; and (c) if the addressee has not designated an information system, receipt occurs when the data message *enters an information system of the addressee*.

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<sup>22</sup> “Information system” is a defined term under article 2, subparagraph (f), of the Model Law and means “a system for generating, sending, receiving, storing or otherwise processing data messages”. Depending on the factual situation, this may indicate “a communications network, and in other instances could include an electronic mailbox or even a telecopier” (*Guide to Enactment of the UNCITRAL Model Law on Electronic Commerce* (United Nations publication, Sales No. E.99.V.4), para. 40).

<sup>23</sup> The notion of “control” over an information system should not be understood as requiring the information system to be located on the premises of the addressee, since “location of information systems is not an operative criterion under the Model Law” (*Guide to Enactment ...*).

<sup>24</sup> It should be noted that the Model Law, as pointed out in its *Guide to Enactment* (para. 104): “does not expressly address the question of possible malfunctioning of information systems as a basis for liability. In particular, where the information system of the addressee does not function at all or functions improperly or, while functioning properly, cannot be entered into by the data message (e.g. in the case of a fax that is constantly occupied), dispatch under the Model Law does not occur. It was felt during the preparation of the Model Law that the addressee should not be placed under the burdensome obligation to maintain its information system functioning at all times by way of a general provision.”

<sup>25</sup> By “designated information system” the Model Law means a system that has been specifically chosen by a party, for instance in the case where an offer expressly specifies the address to which acceptance should be sent. Paragraph 102 of the *Guide to Enactment* clarifies that a “mere indication of an electronic mail or telecopy address on a letterhead or other document should not be regarded as express designation of one or more information systems”.

14. The distinction between “designated” and “non-designated” information systems is intended to establish an appropriate allocation of risks and responsibilities between originator and addressee. The person who designates a specific information system for the receipt of data messages, even if it is a system operated by a third party, should be expected to bear the risk of loss or delay of messages that effectively entered that system. However, if the originator chooses to ignore the addressee’s instructions and sends the message to an information system other than the designated system, it would not be reasonable to consider the message delivered to the addressee until the addressee has actually retrieved it. The rule in the event that no particular system was designated assumes that for the addressee it was a matter of indifference to which information system the messages would be sent, in which case it would be reasonable to presume that it would accept messages through any of its information systems.

15. For both the definition of dispatch and that of receipt, a data message *enters* an information system at the time when it becomes available for processing within that information system. It is not necessary for the recipient to know that the message has been received and there is no additional requirement that the recipient actually read or even access the message. If it reaches the recipient’s “mailbox”, receipt has occurred.

16. Whether the data message is intelligible or usable by the addressee is intentionally outside the purview of the Model Law, which does not set out to overrule provisions of national law under which receipt of a message may occur at the time when the message enters the sphere of the addressee, irrespective of whether the message is intelligible or usable by the addressee.<sup>26</sup>

(b) *Electronic communications in domestic enactments of the Model Law*

17. At the domestic level, there seems to be little disagreement on the proposition that, from a purely factual point of view, the time when a message enters an information system within the addressee’s control or enters an information system outside the sender’s control represent the evident electronic equivalents of the “sphere of control” tests used to define “receipt” and “dispatch” under both the “reception” and the “mailbox” rules.

18. Except for France,<sup>27</sup> the more than 20 countries and non-sovereign jurisdictions that have thus far adopted the Model Law have included provisions on time and place of dispatch and receipt of data messages. Without exception, all

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<sup>26</sup> The *Guide to Enactment* (para. 103) adds that the Model Law is also not intended “to run counter to trade usage, under which certain encoded messages are deemed to be received even before they are usable by, or intelligible for, the addressee. It was felt that the Model Law should not create a more stringent requirement than currently exists in a paper-based environment, where a message can be considered to be received even if it is not intelligible for the addressee or not intended to be intelligible to the addressee (e.g. where encrypted data is transmitted to a depository for the sole purpose of retention in the context of intellectual property rights protection)”.

<sup>27</sup> The French enactment of the Model Law (*Loi n° 2000-230 du 13 mars 2000 portant adaptation du droit de la preuve aux technologies de l’information et relative à la signature électronique*) deals essentially with recognition and evidentiary legal value of electronic records, but does not deal with their communication.

enactments of the Model Law have adopted the distinction between designated and non-designated systems.<sup>28</sup> This is also the case in those countries in which uniform law has been prepared on the basis of the Model Law, such as Canada<sup>29</sup> and the United States of America.<sup>30</sup> That distinction, however, is not explicit in the United States Uniform Electronic Transactions Act (UETA), which contemplates, in addition to a “designated” information system, an information system that the recipient “uses for the purpose of receiving electronic records or information of the type sent and from which the recipient is able to retrieve the electronic record”.<sup>31</sup> Notwithstanding that the language used in UETA differs from article 15 of the Model Law, both instruments distinguish between a system that was positively chosen by a party for the receipt of a particular message or type of message and other (non-designated) information systems merely used by the recipient. The latter category, in much the same way as the non-designated system under article 15 of the UNCITRAL Model Law, was included in UETA out of a concern to “[allow] the recipient of electronic records to retain control over where they would be sent and received”.<sup>32</sup>

<sup>28</sup> Australia (Electronic Transactions Act 1999, sect. 14, subsects. (3) and (4)); Colombia (*Ley Número 527 de 1999: Ley de comercio electrónico*, art. 24, subparas. (a) and (b)); Ecuador (*Ley de comercio electrónico, firmas electrónicas y mensajes de datos* of 2002, art. 11, subparas. (a) and (b)); India (Information Technology Act 2000, sect. 13); Ireland (Electronic Commerce Act, 2000, sect. 21, paras. (2) and (3)); Jordan (Electronic Transactions Law (No. 85) of 2001, art. 17); Mauritius (Electronic Transactions Act 2000, sect. 14 (2)); Mexico (*Decreto por el que se reforman y adicionan diversas disposiciones del Código Civil para el Distrito Federal* of 26 April 2000, art. 91); New Zealand (Electronic Transactions Act 2002, sect. 11, paras. (a) and (b)); Pakistan (Electronic Transactions Ordinance 2002, sect. 15, para. (2)); Philippines (Electronic Commerce Act 2000, sect. 22, paras. (a) and (b)); Republic of Korea (Framework Law on Electronic Commerce, 1999, art. 6, para. (2)); Singapore (Electronic Transactions Act 1998, sect. 15, subpara. (2) (a)); Slovenia (Electronic Commerce and Electronic Signature Act, 2000, art. 10, para. 2); Thailand (Electronic Transactions Act 2002, sect. 23); and Venezuela (*Decreto nº 1024 de 10 de febrero de 2001— Ley sobre mensajes de datos y firmas electrónicas*, art. 11). The same rules are also contained in the laws of the Bailiwick of Jersey (Electronic Communications (Jersey) Law 2000, art. 6), and the Isle of Man (Electronic Transactions Act 2000, sect. 2), both Dependencies of the British Crown; in the British overseas territories of Bermuda (Electronic Transactions Act 1999, sect. 18, para. 2) and Turks and Caicos (Electronic Transactions Ordinance 2000, sect. 16 (2) and (3)); and in the Hong Kong Special Administrative Region of China (Electronic Commerce Ordinance 2000), sect. 19 (2)).

<sup>29</sup> Uniform Electronic Commerce Act (UECA), sect. 23 (2).

<sup>30</sup> Uniform Electronic Transactions Act (UETA), sect. 15 (b).

<sup>31</sup> This formulation is also used in section 23 (b) of the Electronic Communications and Transactions Act 2002 of South Africa.

<sup>32</sup> The drafters of UETA recognized the fact that “many people have multiple e-mail addresses for different purposes. [Subsection 15 (b) of UETA] assures that recipients can designate the e-mail address or system to be used in a particular transaction. For example, the recipient retains the ability to designate a home e-mail for personal matters, work e-mail for official business, or a separate organizational e-mail solely for the business purposes of that organization. If A sends B a notice at his home which relates to business, it may not be deemed received if B designated his business address as the sole address for business purposes. Whether actual knowledge upon seeing it at home would qualify as receipt is determined under the otherwise applicable substantive law” (Amelia H. Boss, “The Uniform Electronic Transactions Act in a global environment”, *Idaho Law Review*, vol. 37, 2001, p. 329).

19. Domestic enactments of the Model Law are also remarkably uniform in defining the time of receipt of data messages sent to a designated system. Nearly all enactments reproduce the rule of paragraph 2 (a) (i) of article 15 of the Model Law, namely, that a message sent to a designated system is received when it enters that system.

20. Minor domestic variations exist with regard to cases in which either the addressee has not designated a particular information system or the originator sends the message to a system other than the designated system. Most domestic enactments of the Model Law make that distinction.<sup>33</sup> In those countries, the consequences are generally the same as in article 15 of the Model Law, that is, a message sent to an information system other than the designated one is only deemed to be received upon retrieval by the addressee,<sup>34</sup> whereas a message sent in the absence of a designated system is deemed to be received upon entry into an information system of the addressee. However, in two countries in that group<sup>35</sup> the law explicitly requires retrieval in both situations.

21. The laws of other countries contemplate only cases where an addressee has not designated an information system.<sup>36</sup> In those countries, receipt normally occurs once the message is “retrieved” or “comes to the attention” of the addressee, but in one country<sup>37</sup> receipt occurs upon entry in a system “regularly used by the addressee”. Two countries contemplate only the hypothesis of a message being sent to an information system other than the designated system, in which case receipt occurs upon retrieval.<sup>38</sup> It is not clear, for that group of countries, whether a message sent to one particular system despite an express designation of another system would follow the same rule. Arguably, both situations would be treated in the same manner, as is suggested by the law of one country,<sup>39</sup> which expressly provides that for all cases other than designated systems, the message is received when it comes to the addressee’s attention.

22. The only apparently significant deviations from article 15 of the Model Law are found in UETA and the Uniform Electronic Commerce Act (UECA) of Canada. Both texts require that the data message be capable of being retrieved and processed by the addressee in addition to entering the addressee’s system.<sup>40</sup> It has been pointed out, in that connection, that the emphasis in the Model Law is on timing.<sup>41</sup> Under the Model Law, the message enters a system when it is available for

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<sup>33</sup> E.g. Bermuda, Colombia, Ecuador, India, Jordan, Mauritius, Mexico, Pakistan, the Philippines and the Republic of Korea.

<sup>34</sup> Some enactments, as in Bermuda, require, instead of “retrieval”, that the message “come to the attention of the addressee”. This does not, in practice, alter the substance of the rule.

<sup>35</sup> Mauritius and Mexico.

<sup>36</sup> E.g. Australia, Canada, Ireland and Venezuela.

<sup>37</sup> Venezuela.

<sup>38</sup> E.g. Slovenia and Thailand.

<sup>39</sup> New Zealand.

<sup>40</sup> UETA, sect. 15 (b) (1) and (2); UECA, sect. 23 (2) (a).

<sup>41</sup> Boss, *loc. cit.*, p. 328.



processing, “whether or not it can in fact be processed”. For UETA and UECA, on the other hand, proper receipt requires that the recipient should be able to retrieve the record from the system and that the message be sent in a form that the addressee’s system can process. Nonetheless, “there is arguably no inconsistency between the UETA and the Model Law”, as it may be understood that the Model Law “defers to national law on the ‘processability’ issue”.<sup>42</sup> Legal analysis and comparison of UETA and the Model Law has indicated, however, that, despite the different formulation, both instruments achieve the same result, as shown in the following example:<sup>43</sup>

“Consider the situation where, because of a power failure or system failure, the system becomes inaccessible, precluding the recipient from ever retrieving the record. The question would be (under both products): when did the failure occur? If it occurred before the electronic record entered the system, then no receipt has yet occurred under either formulation. If the message enters the system, the question initially under the UETA is whether the recipient is able to retrieve it. If the recipient is able to retrieve it, albeit for an instant, receipt has occurred. Subsequent failure of the system should not ‘undo’ what has already occurred. The mere inability of the recipient to retrieve the electronic record at a later point in time is irrelevant once receipt has occurred.”

23. Another situation where both UETA and UECA seem at first sight to differ from the Model Law is when the recipient has designated an information system, but the sender sends the electronic record to another information system. Unlike the Model Law, UETA and UECA do not have specific rules for such a case, which would have to be solved in the light of their more general provisions. The result would probably not be substantially different from the result under the Model Law. If the information system, although not the designated system, was one used by the recipient for electronic records of this type, the record would be deemed received (whether or not it was “actually” retrieved or received). If the system was not generally used for messages of this type, the presumption established by UETA would not apply. Arguably, that presumption would not be needed if the record was actually retrieved by the recipient, which would mean that in practice the result under the Model Law and UETA would be the same. If, however, the record entered an information system of the recipient that was neither the one designated by the recipient, nor the one used by the recipient for such messages, and the record was never retrieved by the recipient, it is claimed that the two laws would again produce the same result: “there would be no receipt under the Model Law (because there was no retrieval), and none under the UETA (because it was not sent to the correct address)”.<sup>44</sup>

(c) *Electronic communications in other domestic laws*

24. The situation in countries that have not adopted the Model Law is not easily ascertainable in view of the scarcity of legal authorities. For the purposes of the

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<sup>42</sup> Boss, loc. cit.

<sup>43</sup> Boss, loc. cit., pp. 330-331.

<sup>44</sup> Boss, loc. cit.

present analysis, those countries may be placed in two broad groups: member States of the European Union (EU) and non-member States of the Union.

25. Very few countries outside EU other than enacting States of the UNCITRAL Model Law have specific legislation on the types of issue related to electronic commerce that have been dealt with by UNCITRAL. Typically, where written laws exist, they deal only with digital signatures (sometimes also other forms of electronic signatures) and certification services<sup>45</sup> and rarely with issues of electronic contracting.<sup>46</sup> The survey done by the Secretariat has not identified legislative provisions on time of dispatch and receipt of data messages in those countries.

26. The situation is different within EU. EU member States are bound to implement the principles set forth in the various EU directives relevant for electronic commerce, in particular Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the internal market.<sup>47</sup> Article 11 of the EU Directive provides that EU member States shall ensure, “except when otherwise agreed by parties who are not consumers”, that a customer’s order and the acknowledgement of receipt of the order by the merchant “are deemed to be received when the parties to whom they are addressed are able to access them”. Under the EU legislative system, member States are left with the choice of the means to achieve the result envisaged by the EU Directive.

27. When, however, are the parties “able to access” data messages and which kind of “ability” is meant by the EU Directive? Is it sufficient that the parties have the abstract possibility of gaining access to the data message, or is it necessary for the addressee to be actually in a position to retrieve the message? The preamble to the EU Directive does not explain the precise meaning of the words “able to access”. While a number of language versions favour a more general formulation,<sup>48</sup> some of them seem to imply that the addressee must be actually able to retrieve the message.<sup>49</sup>

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<sup>45</sup> This is the case, for example, of the laws of Argentina (*Ley No. 25.506—“Ley de Firma Digital”* and *Decreto No. 2628/2002 (Firma Digital), Reglamentación de la Ley No. 25.506*); Estonia (Digital Signatures Act, 2000); Israel (Electronic Signatures Act, 2000); Japan (Law concerning Electronic Signatures and Certification Services, 2001); Lithuania (Law on Electronic Signatures, 2000); Malaysia (Digital Signatures Act, 1997); Poland (Electronic Signatures Act, 2001); and Russian Federation (Law on Electronic Digital Signature (Federal Act No. 1-FZ) of 10 January 2002).

<sup>46</sup> One example is Tunisia, which has enacted legislation on electronic commerce (*Loi relative aux échanges et au commerce électroniques* of 9 August 2000) that contains provisions on electronic contracting inspired by Directive 97/7/EC of the European Parliament and of the Council of 20 May 1997 on the protection of consumers in respect of distance contracts (*Official Journal of the European Communities*, No. L 144, 4 June 1997, pp. 19-27).

<sup>47</sup> *Official Journal of the European Communities*, No. L 17, 17 July 2000.

<sup>48</sup> This seems to be the case for the French (“*lorsque les parties [...] peuvent y avoir accès*”), Italian (“*quando le parte [...] hanno la possibilità di acedervi*”), Portuguese (“*quando as partes [...] têm possibilidade de aceder a estes*”) and Spanish (“*cuando las partes [...] puedan tener acceso a los mismos*”) texts.

<sup>49</sup> For instance, the German text (“*wenn die Parteien, für die sie bestimmt sind, sie abrufen*”

28. Arguably, the linguistic nuances in the various language versions of the EU Directive are not substantive. The main difficulty in fact seems to be that the formulation in article 11 of the EU Directive does not provide a presumption or indication of the time from which a party should be deemed to have been “able to access” a message. To date, a number of EU member States have enacted specific legislation to implement the EU Directive. Austria,<sup>50</sup> Denmark,<sup>51</sup> Germany,<sup>52</sup> Ireland,<sup>53</sup> Italy,<sup>54</sup> Spain<sup>55</sup> and the United Kingdom of Great Britain and Northern Ireland<sup>56</sup> have reproduced the formulation used in article 11 of the EU Directive with only slight changes.<sup>57</sup>

29. It is not entirely clear which rule applies in countries such as Ireland<sup>58</sup> and Italy<sup>59</sup> that already had statutory provisions on time of dispatch and receipt of data messages before the adoption of the EU Directive. The Irish law contains essentially the same rule as article 15 of the Model Law. The new law implementing the EU Directive provides that the specific rule on receipt of an “order” applies “notwithstanding” the earlier law. The rule in Italy is that an electronic document is deemed to have been dispatched by the originator and received by the addressee if it is “transmitted to the electronic address” indicated by the addressee.<sup>60</sup> Although different in formulation, this rule would arguably lead in most cases to the same result as that of article 15 of the Model Law.

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können”).

<sup>50</sup> See “Bundesgesetz mit dem bestimmte rechtliche Aspekte des elektronischen Geschäfts- und Rechtsverkehrs geregelt (E-Commerce-Gesetz—ECG) und Änderung des Signaturgesetzes sowie der Zivilprozessordnung” (Bundesgesetzblatt für die Republik Österreich, 21 December 2001, p. 1977), sect. 12.

<sup>51</sup> See *Lov om tjenester i informationssamfundet, herunder visse aspekter af elektronisk handel*, sect. 12 (2).

<sup>52</sup> Article 11 of the EU Directive has been incorporated in the new section 312e(1) of the German Civil Code (BGR).

<sup>53</sup> See European Communities (Directive 2000/31/EC) Regulations 2003, sect. 14 (1) (b).

<sup>54</sup> See *Decreto legislativo 9 aprile 2003, n. 70*, art. 13, para. 3.

<sup>55</sup> See *Ley 34/2002, de 11 de julio, de servicios de la sociedad de la información y de comercio electrónico*, art. 28, para. 2.

<sup>56</sup> See Electronic Commerce (EC Directive) Regulations 2002 (Statutory Instrument 2002 No. 2013), sect. 11 (2).

<sup>57</sup> Section 312e(1) of the German Civil Code provides that an order and the acknowledgement of its receipt are deemed to have been received when the parties to whom they are addressed are able to retrieve them “under normal circumstances” (“*unter gewöhnlichen Umständen*”). The same formulation is used in the Austrian law. The Spanish law refers to the addressee’s ability to become aware (“*tener constancia*”) of the message, rather than “access” (“*tener acceso*”) the message

<sup>58</sup> Electronic Commerce Act 2000, sect. 13, paras. (2) (a) and (b)).

<sup>59</sup> *Decreto del Presidente della Repubblica 10 novembre 1997, n. 513*, art. 12, para. 1.

<sup>60</sup> “*Il documento informatico trasmesso per via telematica si intende inviato e pervenuto al destinatario se trasmesso all’indirizzo elettronico da questi dichiarato*” (*Decreto del Presidente della Repubblica 10 novembre 1997, n. 513*).

30. Most of the countries that have implemented the EU Directive, however, did not have statutory rules on time of dispatch and receipt of data messages, although case law in some of them already provided criteria for the transposition to an electronic environment of traditional rules on dispatch and receipt. The result is typically consistent with article 15 of the UNCITRAL Model Law. This is true even in countries such as Germany, which have not enacted the Model Law, where the courts have regarded the delivery of a message to a party's e-mail address, for instance, as the equivalent of "receipt", regardless of whether or not the party had actually accessed the message.<sup>61</sup> Incomplete delivery of the text of a data message, owing, for instance to technical malfunctioning of the receiving equipment, does not exclude "receipt", if there is evidence that the message was transmitted entirely in electronic form.<sup>62</sup> While proof of proper dispatch of a data message may be regarded as prima facie evidence of its effective receipt by the other party,<sup>63</sup> the courts have also stressed that the originator of a data message is not entitled to rely on mere dispatch of the message, which creates no presumption that the message was actually received.<sup>64</sup>

31. The fact, however, that the EU Directive introduced the "accessibility" criterion to determine the time of receipt of data messages has caused some concern,

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<sup>61</sup> See, for example, Landgericht Nürnberg-Fürth, Case No. 2 HK O 9431/01, 7 May 2002, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 158/2003 (available at [www.jurpc.de/rechtspr/20030158.htm](http://www.jurpc.de/rechtspr/20030158.htm), accessed on 8 September 2003). In this case, the claimant's contract was terminated by the defendant through registered mail, which was later confirmed by an electronic message sent to the claimant's e-mail address. The claimant challenged the effectiveness of the e-mail message, arguing that he had not been able to retrieve it, since the message was sent during his holiday and his e-mail account was not accessible through ordinary web browsers. The court held that the claimant had effectively received the message, as it had been delivered to his e-mail address. From that time on, the claimant bore the risk of loss of the message or delay in retrieving the message, for instance due to difficulties in accessing his e-mail account, as such a risk occurred within the claimant's sphere of control.

<sup>62</sup> See Bundesgerichtshof, Case No. XII ZR 51/99, 14 March 2001, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 167/2001 (available at [www.jurpc.de/rechtspr/20010167.htm](http://www.jurpc.de/rechtspr/20010167.htm), accessed on 9 September 2003). In this case, a court of appeals had rejected an appeal because the facsimile received did not contain counsel's signature, which would have been contained in the fourth page of the statement of appeal, which the court did not receive. The Federal Court disagreed with the position taken by the court of appeals that only the pages received by it could be taken into account in determining whether the statement of appeal had been delivered within the deadline for its submission. The Federal Court held that when a document was completely ("vollständig") transmitted as a data message ("durch elektrische Signale") from the appellant's facsimile to the court's machine, but did not get printed completely and without errors, possibly as a result of technical malfunctioning at the destination, the document was deemed to have been received at the time of its transmission as a facsimile, as long as the entire content of the document could be established through other means.

<sup>63</sup> In particular in the case of highly reliable transmission methods, in view of the current stage of technological development, such as facsimile transmissions (see Oberlandesgericht München, Case No. 15 W 2631/98, 8 October 1998, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 153/1999, available at [www.jurpc.de/rechtspr/19990153.htm](http://www.jurpc.de/rechtspr/19990153.htm), accessed on 9 September 2003).

<sup>64</sup> See Oberlandesgericht Düsseldorf, Case No. 23 U 92/02, 4 October 2002, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 167/2003 (available at [www.jurpc.de/rechtspr/20030158.htm](http://www.jurpc.de/rechtspr/20030158.htm), accessed on 9 September 2003), in a case involving e-mail messages.

as it was felt that the rule in the EU Directive should not be carried so far as to require actual retrieval of messages, a result that would conflict with existing case law. Indeed, it appears from the consultation process preceding the implementation of the EU Directive in some countries that some of the changes introduced in domestic legislation were intended to avoid the impression that receipt of a message required actual retrieval by the addressee. The final rule, it was said, should instead make it clear that only the “technical possibility” of retrieval was relevant, and not the addressee’s “availability” for retrieving the message.<sup>65</sup>

(d) *The debate within the Working Group*

32. The preliminary draft convention has followed closely the structure and formulation of article 15 of the UNCITRAL Model Law on Electronic Commerce. This was a natural choice in view of the wide acceptance of that provision of the Model Law. It also had the additional advantage of its compatibility with article 24 of the United Nations Sales Convention.<sup>66</sup> This provision, however, has caused extensive debate within the Working Group (see A/CN.9/509, paras. 93-98; and A/CN.9/528, paras. 141-151).

33. One criticism has been that the provision is overly complex and that there may be no practical need for distinguishing between designated and non-designated information systems. That criticism was formulated in the following terms in a statement by the German Bar Association on the preliminary draft convention:<sup>67</sup>

“A point requiring clarification seems to be the distinction in article 11, paragraph 2 [*draft art. 10, para. 2 in document A/CN.9/WG.IV/WP.103*], between an information system designated by the addressee for the receipt of data messages and a system other than the designated system. This distinction is more relevant for Electronic Data Interchange (EDI), but not for e-mail communications. The consequence is that, in the context of e-mail communications, the decisive factor should be the actual entry of the data message in the recipient’s computer station. This does not flow from article 11 (2) with the clarity required for legal harmonization.

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<sup>65</sup> This point was made expressly in the explanatory note to the draft bill introduced to implement the EU Directive in Austria. The Austrian Bar Association, in its comments on the draft bill, proposed that the law clearly provide that the only controlling factor was the technical “retrievability” (*Abrufbarkeit*) and that neither technical malfunctioning on the addressee’s part nor the addressee’s absence nor any other obstacle within the addressee’s sphere of control should hinder the effective receipt of the message (Rechtsanwaltskammer Wien, *Stellungnahme zum Bundesgesetz mit dem bestimmte rechtliche Aspekte des elektronischen Geschäfts- und Rechtsverkehrs geregelt werden (E-Commerce-Gesetz—ECG)*, 31 August 2001, available at [www.rakwien.at/import/documents/stellungnahme\\_ecommerce\\_fuer\\_homepage.pdf](http://www.rakwien.at/import/documents/stellungnahme_ecommerce_fuer_homepage.pdf), accessed on 8 September 2003).

<sup>66</sup> Sieg Eiselen, “E-Commerce and the CISG: formation, formalities and validity”, *Vindobona Journal of International Commercial Law and Arbitration*, vol. 6, No. 2 (2002), pp. 310-311.

<sup>67</sup> *Stellungnahme der Bundesrechtsanwaltskammer: UNCITRAL-Übereinkommensentwurf über internationale Verträge, die mit elektronischen Mitteln geschlossen oder nachgewiesen werden*, submitted in March 2002 by the Committee on Private International Law and International Procedural Law (Ausschuss Internationales Privat- und Prozessrecht) (available at [www.brak.de/seiten/pdf/EndfUNCITRAL-Uebereinkentwurf.pdf](http://www.brak.de/seiten/pdf/EndfUNCITRAL-Uebereinkentwurf.pdf), accessed on 8 September 2003).

“On the basis of the definition in article 5 (f) [...], an ‘information system’ means ‘a system for generating, sending, receiving, storing or otherwise processing data messages’. This wide definition encompasses not only a provider’s web server, but also the computer stations of the provider’s clients, from which they retrieve their messages or through which they forward their messages to the provider for transmission to the addressees. It is important in this connection to clarify whether the entry in the provider’s server is sufficient to establish the receipt of the message, or whether the data message needs to be actually retrieved by the addressee at its computer station.

“This distinction depends on whether the addressee has designated a particular information system for the receipt of the data message and which is the designated system. Normally, the user does not make use of system-specification (*Systembenennung*) as a “receipt-address” (*Zustelladresse*), but rather uses an e-mail address, from which no specified system is recognizable. A specification should not in fact be necessary, since, in protocol-based Internet data communication, messages are transmitted without empty signs through special computers that use appropriate destination tables.

“On this technical basis, article 11, paragraph 2 [*draft art. 10, para. 2, in document A/CN.9/WG.IV/WP.103*], would become idle, because the originator is not provided with a specific system of destination, and only requires an e-mail address, which is independent from a computer station. The transmission of the message to *another*, non-designated system (article 11, paragraph 2, first sentence, second phrase) does not occur, since to that end there should have been a designated system in the first place.”

34. The problems identified in this analysis may in fact be significant if the notion of “information system” is understood to refer to the telecommunication channels and infrastructure used to transport messages to their final destination, rather than to the “electronic address” designated by a party for the purpose of receiving messages. As understood thus far, however, the notion of “information system” is intended to cover “the entire range of technical means used for transmitting, receiving and storing information”, which, depending on the factual situation, may be “a communications network, and in other instances could include an electronic mailbox or even a telecopier”.<sup>68</sup> The same broad interpretation should be given in the context of the preliminary draft convention. Nevertheless, the Working Group may wish to consider whether it might be useful to formulate an appropriate clarification in the definition of “information system” in draft article 5, subparagraph (e). The Working Group may further wish to consider whether some explanation should be given as to what actions should be regarded as a “designation” of an information system by the addressee.<sup>69</sup> Moreover, the Working Group may wish to consider the relationship between an e-mail address as a

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<sup>68</sup> *Guide to Enactment ...*, para. 40.

<sup>69</sup> The remarks by the German Bar Association seem indeed to be based on the perception that, for the purposes of the Model Law, an e-mail address could not be a “designated information system” in view of the statement, in paragraph 102 of the *Guide to Enactment*, that “the mere indication of an electronic mail or telecopy address on a letterhead or other document should not be regarded as express designation of one or more information systems”.

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designated “information system” and the system used to deliver messages to mailboxes carrying a particular extension (e.g. “@XYZ.com”).

35. Another criticism has been that the rule of article 15 of the Model Law might be excessively rigid because the entry of a message in the addressee’s system or another system designated by the addressee does not always allow the conclusion that the addressee is capable of accessing the message. It has been proposed that the notion of “entry” should be rendered more flexible by adding the notion of “accessibility” of the data message, which would be given when the message is capable of being “processed and retrieved by the addressee” (A/CN.9/509, paras. 94 and 96). One proposal would link the receipt to “the time when the retrieval of that data message by the addressee” could “normally be expected” (A/CN.9/528, para. 148). However, there were also objections to that proposal, as the reference to the time when the addressee could “normally be expected” to “retrieve” might deviate from the accepted notion of “availability” of the message for processing within an information system, as an objective test, towards a more subjective approach (A/CN.9/528, para. 149).

36. There seems to be no disagreement with the general objective of developing default rules on dispatch and receipt of messages that aim at establishing a fair allocation of risks and responsibilities between the originator and the addressee (A/CN.9/528, para. 145). In principle, it should not be difficult to reach international consensus on the principle that a person who manages an information system, or designates a specific information system for the receipt of data messages, even if it is a system operated by a third party, should bear the risk of loss or delay of messages that have effectively entered that system. This point, however, highlights the importance of a clear understanding of the meaning of “information system”, in particular where the parties communicate through e-mail.

37. Where no specific system has been designated, the rule should be such that it would allow a judge or arbitrator called to decide upon a dispute on the time of receipt of a data message to apply a test of reasonableness to the choice of an information system by the originator in the absence of a clear designation by the addressee.

38. The Working Group may wish to consider possible ways of bridging the gap between the opposing views on this aspect of draft article 10. One possibility, which has been proposed even in connection with systems that follow the “information theory” for the purposes of contract formation, might be to attach a presumption of

knowledge (in the sense of “accessibility” or “possibility of knowledge”) of a message to the effective delivery of a message to the addressee’s information system. It would thus be for the addressee to adduce evidence that, through no fault of its own or of any intermediary of its choosing, it could not access the message.<sup>70</sup>

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<sup>70</sup> Giovanni Comandé and Salvatore Sica, *Il commercio elettronico* (Turin, G. Giappichelli, 2001), p. 57. The authors propose this approach as a combined interpretation of articles 1136 (which requires the offeror’s “knowledge” of the acceptance for contract formation) and 1135 (which provides that the party’s knowledge is presumed when the acceptance was communicated to an appropriate address), both of the Italian Civil Code, and article 12, subparagraph (I), of Decree No. 513/1997 (which provides that an electronic document is deemed to have been received by the addressee when it has been “transmitted” to the electronic address indicated by it). The authors point out that such an interpretation would also be in line with the notion of “accessibility” of a data message for the purposes of the EU Directive.



**Note by the Secretariat on legal aspects of electronic commerce:  
electronic contracting: background information, working paper submitted  
to the Working Group on Electronic Commerce at its forty-second session**

ADDENDUM

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### **III. Issues related to the use of data messages in international contracts**

1. The following sections deal with issues that are either specific to contracting through electronic means or may be rendered particularly conspicuous by the use of modern means of communication. In section C issues related to the appropriateness of authentication methods and criteria for attribution of data messages are discussed, while in section D legal questions arising out of the use of fully automated systems used in electronic commerce, including mistake and error, are examined. Availability of contract terms and information obligations that might be imposed upon parties using electronic information systems are dealt with in section E. Both sections D and E appear in a further addendum (A/CN.9/WG.IV/WP.104/Add.4).

#### **C. Form requirements**

2. The preliminary draft convention on electronic contracting follows the general principle of freedom of form enshrined in the United Nations Convention on Contracts for the International Sale of Goods ("the United Nations Sales

Convention”)<sup>1</sup> and extends it to all contracts falling within its sphere of application. However, it is recognized that form requirements may exist under the applicable law as writing or signature requirements, for example when a State party to the United Nations Sales Convention has made a reservation under article 96 of the Convention.<sup>2</sup> Even where form requirements as such do not exist, obstacles to the use of data messages may derive from rules on evidence that expressly or implicitly limit the parties’ ability to use data messages as evidence to demonstrate the existence and content of contracts.

#### 1. Writing requirements and evidentiary value of electronic records

3. Despite the wide acceptance that the UNCITRAL Model Law on Electronic Commerce (“the Model Law”) has found and the increasing number of States that have based their legislation on electronic commerce on it, an international instrument on electronic contracting could not be based on the assumption that the principles of the Model Law have already achieved universal application. It seems, therefore, useful for the new instrument to establish the conditions under which form requirements may be met by equivalent electronic methods.

4. There are not many court decisions on the legal value of electronic records. The few reported cases show an evolution towards legal recognition of electronic records and data messages, but also some uncertainty as to their admissibility both as a means for the formation of contracts and as evidence of the content of contracts.

5. In the United States of America, the courts seem to have taken a liberal approach to the admissibility of electronic records, including electronic mail (e-mail), as evidence in civil proceedings.<sup>3</sup> Courts in the United States have dismissed arguments that e-mail messages were inadmissible evidence because they were unauthenticated and parol evidence.<sup>4</sup> The courts have found instead that

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<sup>1</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567, p. 3 (also available at [www.uncitral.org/english/texts/sales/CISG.htm](http://www.uncitral.org/english/texts/sales/CISG.htm)).

<sup>2</sup> Under that provision:

“A Contracting State whose legislation requires contracts of sale to be concluded in or evidenced by writing may at any time make a declaration in accordance with article 12 that any provision of article 11, article 29, or Part II of this Convention, that allows a contract of sale or its modification or termination by agreement or any offer, acceptance, or other indication of intention to be made in any form other than in writing, does not apply where any party has his place of business in that State.”

<sup>3</sup> *Commonwealth Aluminum Corporation v. Stanley Metal Associates*, United States District Court for the Western District of Kentucky, 9 August 2001, Federal Supplement, 2nd series, vol. 186, p. 770; and *Central Illinois Light Company (CILCO) v. Consolidation Coal Company (Consol)*, United States District Court for the Central District of Illinois, 30 December 2002, Federal Supplement, 2nd series, vol. 235, p. 916.

<sup>4</sup> In *Sea-Land Service, Inc. v. Lozen International, Llc.*, for example, a court of appeal reversed a decision by a district court that had excluded an internal company e-mail authored by one plaintiff’s employees. The district court excluded this evidence on the ground that the defendant “makes no argument, nor does it present any evidence indicating the identity or job title of [the] employee” who authored the e-mail. The court of appeal noted that the original e-mail, an internal company memorandum, closed with an electronic “signature” indicating the name and function of the drafter. The district court had therefore abused its discretion when it excluded the e-mail as evidence (United States Court of Appeals for the Ninth Circuit, 3 April 2002,

e-mails obtained from the plaintiff during the discovery process were self-authenticating, since “the production of documents during discovery from the parties’ own files is sufficient to justify a finding of self-authentication”.<sup>5</sup> The courts tend to take into account all available evidence and do not reject electronic records as being prima facie insufficient evidence.

6. However, in some countries that have not adopted the Model Law, electronic records, in particular those resulting from Internet transactions, have been said to be “devoid of legal value”.<sup>6</sup> Moreover, concerns about the risk of manipulation in electronic records have led to court decisions that dismiss the value, for instance, of e-mails as evidence in court proceedings on the grounds that e-mails do not offer adequate guarantees of integrity.<sup>7</sup>

7. Case law on this issue is still at an incipient stage and, given the small number of court decisions to date, does not provide a sufficient basis to draw firm conclusions. Nevertheless, it could be argued that international commerce might benefit from the enhanced legal certainty that would result from uniform provisions that offered criteria for the recognition of electronic records and data messages in international trade. Article 9, paragraph 2, of the preliminary draft convention reproduces, for that purpose, the criteria contained in article 6 of the Model Law for the legal recognition of data messages as “writings”.

## 2. Attribution of messages and signature requirements

8. The use of electronic methods of identification involves two aspects that may deserve consideration by the Working Group. The first aspect relates to the general issue of attribution of a message to its purported originator. The second aspect relates to the appropriateness of the identification method used by the parties for the purpose of meeting legal form requirements, in particular signature requirements. Also relevant are legal notions that imply the existence of a handwritten signature, as is the case for the notion of “document” in some legal systems. Even though these two aspects may often be combined or, depending on the circumstances, may not be entirely distinguishable one from another, an attempt to analyse them separately may be useful, as it appears that courts tend to reach different conclusions according to the function being attached to the identification method.

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Federal Reporter, 3rd series, vol. 285, p. 808).

<sup>5</sup> *Superhighway Consulting, Inc. v. Techwave, Inc.*, United States District Court for the Northern District of Illinois, Eastern Division, 16 November 1999, U.S. Dist. LEXIS 17910.

<sup>6</sup> (Undated) statement by Judge Ruy Rosado de Aguiar Jr. of the Brazilian Superior Tribunal de Justiça (“*Comércio eletrônico não tem valor jurídico*”, at [www.trabalhodeeconomia.hpg.ig.com.br/juri.html](http://www.trabalhodeeconomia.hpg.ig.com.br/juri.html), accessed on 12 September 2003).

<sup>7</sup> Amtsgericht Bonn, Case No. 3 C 193/01, 25 October 2001, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 332/2002 (available at [www.jurpc.de/rechtspr/20020332.htm](http://www.jurpc.de/rechtspr/20020332.htm), accessed on 11 September 2003). In this case, the claimant sued the defendant demanding payment of a broker’s fee for acting as an intermediary in a bulk sale of cigarettes. The court dismissed the claim for lack of proof of an agreement for the payment of a fee. The court held that the e-mail printouts produced by the claimant and repudiated by the defendant had no value as evidence, as it is “generally known” that ordinary e-mails can be easily altered or forged.

(a) *Attribution of data messages*

9. The Model Law deals with attribution of data messages in its article 13. That provision has its origin in article 5 of the UNCITRAL Model Law on International Credit Transfers, which defines the obligations of the sender of a payment order. Article 13 is intended to apply where there is a question as to whether a data message was really sent by the person who is indicated as being the originator. In the case of a paper-based communication the problem would arise as the result of an alleged forged signature of the purported originator. In an electronic environment, an unauthorized person may have sent the message but the authentication by code, encryption or the like would be accurate. The purpose of article 13 is not to assign responsibility. It deals rather with attribution of data messages by establishing a presumption that under certain circumstances a data message would be considered a message of the originator.

10. Article 13, paragraph 1, of the Model Law recalls the principle that an originator is bound by a data message if it has effectively sent that message. Paragraph 2 refers to a situation where the message was sent by a person other than the originator who had the authority to act on behalf of the originator. Paragraph 3 deals with two kinds of situation in which the addressee could rely on a data message as being that of the originator: firstly, situations in which the addressee properly applied an authentication procedure previously agreed to by the originator; and, secondly, situations in which the data message resulted from the actions of a person who, by virtue of his or her relationship with the originator, had access to the originator's authentication procedures.

11. A number of countries have adopted the rule in article 13 of the Model Law, including the presumption of attribution established in paragraph 3 of that article.<sup>8</sup> Some countries expressly refer to the use of codes, passwords or other means of identification as factors that create a presumption of authorship.<sup>9</sup> There are also more general versions of article 13, in which the presumption created by proper verification through a previously agreed procedure is rephrased as an indication of elements that may be used for attribution purposes.<sup>10</sup>

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<sup>8</sup> See Colombia (*Ley Número 527 de 1999: Ley de comercio electrónico*, art. 17); Ecuador (*Ley de comercio electrónico, firmas electrónicas y mensajes de datos*, 2002, art. 10); Jordan (Electronic Transactions Law (No. 85) of 2001, art. 15); Mauritius (Electronic Transactions Act, 2000, section 12(2)); Philippines (Electronic Commerce Act, 2000, sect. 18, para. (3)); Republic of Korea (Framework Law on Electronic Commerce, 1999, art. 7, para. (2)); Singapore (Electronic Transactions Act, 1998, subsect. 13 (3)); Thailand (Electronic Transactions Act, 2002, sect. 16); and Venezuela (*Decreto n° 1024 de 10 de febrero de 2001—Ley sobre mensajes de datos y firmas electrónicas*, art. 9). The same rules are also contained in the laws of the British Crown Dependency of Jersey (Electronic Communications (Jersey) Law 2000, art. 8), and the British overseas territories of Bermuda (Electronic Transactions Act, 1999, sect. 16, para. 2) and Turks and Caicos (Electronic Transactions Ordinance, 2000, sect. 14).

<sup>9</sup> Mexico (*Decreto por el que se reforman y adicionan diversas disposiciones del Código Civil para el Distrito Federal* of 26 April 2000, art. 90, para. 1).

<sup>10</sup> For example, the United States Uniform Electronic Transactions Act (UETA), provides in section 9 (a) that an electronic record or electronic signature "is attributable to a person if it was the act of the person. The act of the person may be shown in any manner, including a showing of the efficacy of any security procedure applied to determine the person to which the electronic record or electronic signature was attributable". Section 9 (b) provides further that the effect of

12. Other countries, however, have adopted only the general rules in article 13 that a data message is that of the originator if it was sent by the originator itself or by a person acting on the originator's behalf, or by a system programmed by or on behalf of the originator to operate automatically.<sup>11</sup> Lastly, a few countries that have implemented the Model Law have not included any specific provision based on article 13.<sup>12</sup> The assumption in those countries was that no specific rules were needed and that attribution was better left to ordinary methods of proof, the same way as attribution of documents on paper: "The person who wishes to rely on any signature takes the risk that the signature is invalid, and this rule does not change for an electronic signature."<sup>13</sup>

13. In countries that have not adopted the Model Law, there seem to be no specific legislative provisions dealing with attribution in an analogous fashion. In those countries, attribution is typically a function of the legal recognition of electronic signatures and the presumptions attached to records authenticated with particular types of electronic signature.

14. Thus far, the preliminary draft convention has not included specific rules on attribution on the basis of article 13 of the Model Law. The Working Group may wish to consider, however, whether it might be useful to consider formulating provisions on attribution separately from provisions on electronic signatures. The reason for such an approach is that signatures are not the only method of identification recognized by law to attribute documents and records to a given person, as the official comments to the relevant provision of the United States Uniform Electronic Transactions Act (UETA) explain:<sup>14</sup>

"1. Under subsection (a) [of UETA section 9], so long as the electronic record or electronic signature resulted from a person's action it will be attributed to that person—the legal effect of that attribution is addressed in subsection (b). This section does not alter existing rules of law regarding attribution. The section assures that such rules will be applied in the electronic environment. A person's actions include actions taken by human agents of the

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an electronic record or electronic signature attributed to a person under subsection (a) "is determined from the context and surrounding circumstances at the time of its creation, execution, or adoption, including the parties' agreement, if any, and otherwise as provided by law".

<sup>11</sup> Australia (Electronic Transactions Act, 1999, sect. 15, subsect. (1)); essentially in the same manner, India (Information Technology Act, 2000, sect. 11); Pakistan (Electronic Transactions Ordinance, 2002, sect. 13 (2)); Slovenia (Electronic Commerce and Electronic Signature Act, 2000, art. 5); in the British Crown Dependency of the Isle of Man (Electronic Transactions Act, 2000, sect. 2); and in the Hong Kong Special Administrative Region of China (Electronic Commerce Ordinance, 2000, sect. 18).

<sup>12</sup> For example, Canada, France, Ireland, New Zealand and South Africa.

<sup>13</sup> Uniform Law Conference of Canada, *Uniform Electronic Commerce Act (Annotated)*, commentary to section 10 (2) (available at [www.ulcc.ca/en/poam2/index.cfm?sec=1999&sub=1999ia](http://www.ulcc.ca/en/poam2/index.cfm?sec=1999&sub=1999ia), accessed on 11 September 2003).

<sup>14</sup> National Conference of Commissioners on Uniform State Laws, *Uniform Electronic Transactions Act (1999)*, approved and recommended for enactment in all the states at its 108th annual conference meeting (Denver, Colorado, 23-30 July 1999), with prefatory note and comments (available at [www.law.upenn.edu/bll/ulc/fnact99/1990s/ueta99.htm](http://www.law.upenn.edu/bll/ulc/fnact99/1990s/ueta99.htm), accessed on 11 September 2003).

person, as well as actions taken by an electronic agent, i.e., the tool, of the person. Although the rule may appear to state the obvious, it assures that the record or signature is not ascribed to a machine, as opposed to the person operating or programming the machine.

“In each of the following cases, both the electronic record and electronic signature would be attributable to a person under subsection (a):

- “A. The person types his/her name as part of an e-mail purchase order;
- “B. The person’s employee, pursuant to authority, types the person’s name as part of an e-mail purchase order;
- “C. The person’s computer, programmed to order goods upon receipt of inventory information within particular parameters, issues a purchase order which includes the person’s name, or other identifying information, as part of the order.

“In each of the above cases, law other than [UETA] would ascribe both the signature and the action to the person if done in a paper medium. Subsection (a) expressly provides that the same result will occur when an electronic medium is used.

“2. Nothing in [UETA section 9] affects the use of a signature as a device for attributing a record to a person. Indeed, a signature is often the primary method for attributing a record to a person. In the foregoing examples, once the electronic signature is attributed to the person, the electronic record would also be attributed to the person, unless the person established fraud, forgery, or other invalidating cause. However, a signature is not the only method for attribution.

“3. The use of facsimile transmissions provides a number of examples of attribution using information other than a signature. A facsimile may be attributed to a person because of the information printed across the top of the page that indicates the machine from which it was sent. Similarly, the transmission may contain a letterhead which identifies the sender. Some cases have held that the letterhead actually constituted a signature because it was a symbol adopted by the sender with intent to authenticate the facsimile. However, the signature determination resulted from the necessary finding of intention in that case. Other cases have found facsimile letterheads NOT to be signatures because the requisite intention was not present. The critical point is that with or without a signature, information within the electronic record may well suffice to provide the facts resulting in attribution of an electronic record to a particular party.

“In the context of attribution of records, normally the content of the record will provide the necessary information for a finding of attribution. It is also possible that an established course of dealing between parties may result in a finding of attribution. Just as with a paper record, evidence of forgery or counterfeiting may be introduced to rebut the evidence of attribution.

“4. Certain information may be present in an electronic environment that does not appear to attribute but which clearly links a person to a particular record. Numerical codes, personal identification numbers, public and private

key combinations all serve to establish the party to whom an electronic record should be attributed. Of course security procedures will be another piece of evidence available to establish attribution.

“The inclusion of a specific reference to security procedures as a means of proving attribution is salutary because of the unique importance of security procedures in the electronic environment. In certain processes, a technical and technological security procedure may be the best way to convince a trier of fact that a particular electronic record or signature was that of a particular person. In certain circumstances, the use of a security procedure to establish that the record and related signature came from the person’s business might be necessary to overcome a claim that a hacker intervened. The reference to security procedures is not intended to suggest that other forms of proof of attribution should be accorded less persuasive effect. It is also important to recall that the particular strength of a given procedure does not affect the procedure’s status as a security procedure, but only affects the weight to be accorded the evidence of the security procedure as tending to establish attribution.”

15. It also seems important to bear in mind that a presumption of attribution would not by itself displace the application of rules of law on signatures, where a signature is needed for the validity or proof of an act. Once it is established that a record or signature is attributable to a particular party, “the effect of a record or signature must be determined in light of the context and surrounding circumstances, including the parties’ agreement, if any” as well as of “other legal requirements considered in light of the context”.<sup>15</sup>

16. Examples of a more restrictive approach to attribution can be found in recent cases involving Internet auctions, in which courts have applied a high standard for attribution of data messages. Those cases have typically involved suits for breach of contract on grounds of lack of payment for goods allegedly purchased in Internet auctions. Claimants maintained that defendants were the buyer, as the highest bid for the goods had been authenticated with the defendant’s password and had been sent from the defendant’s e-mail address. The courts have found that those elements were not sufficient to firmly conclude that it was in fact the defendant who had participated in the auction and submitted the winning bid for the goods. The courts have used various arguments to justify that position. For example, passwords were not reliable because anyone who knew the defendant’s password could have used its e-mail address from anywhere and participated in the auction using the defendant’s name,<sup>16</sup> a risk that some courts, on the basis of expert advice on security threats to Internet communications networks, in particular through the use of so-called “Trojan horses” capable of “stealing” a person’s password, estimated as “very high”.<sup>17</sup> The risk of unauthorized use of a person’s identification device (password)

<sup>15</sup> Ibid.

<sup>16</sup> Amtsgericht Erfurt, Case No. 28 C 2354/01, 14 September 2001, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 71/2002 (available at [www.jurpc.de/rechtspr/20020071.htm](http://www.jurpc.de/rechtspr/20020071.htm), accessed on 25 August 2003).

<sup>17</sup> Landgericht Konstanz, Case No. 2 O 141/01 A, 19 April 2002, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 291/2002 (available at [www.jurpc.de/rechtspr/20020291.htm](http://www.jurpc.de/rechtspr/20020291.htm), accessed on 25 August 2003).

should be borne by the party that offered goods or services through a particular medium, as there was no legal presumption that messages sent through an Internet web site with recourse to a person's access password to such web site were attributable to that person.<sup>18</sup> Such a presumption might conceivably be attached to an "advance electronic signature", as defined in law, but the holder of a simple "password" should not bear the risk of its being misused by unauthorized persons.<sup>19</sup>

17. Uniform rules for attribution of data messages may be useful to enhance legal certainty as to the elements upon which a party may rely for the attribution of responsibility for data messages. Such rules could be formulated as a presumption, using the elements of article 13 of the Model Law. They may have the additional advantage of limiting the scope of issues expected to be solved by common standards on electronic signatures, which often serve a different purpose.

(b) *Signature requirements*

18. As regards signature requirements, one question that the Working Group needs to consider is whether the preliminary draft convention should limit itself to a general provision on the recognition of electronic signatures or whether it should spell out the conditions for the legal recognition of electronic signatures in a greater level of detail. Under the first option, the Working Group might wish to introduce in the new instrument a provision along the lines of article 7, paragraph 1, of the Model Law. That option is reflected in variant A of paragraph 3 of draft article 9. Under the second option, the Working Group would use more detailed language along the lines of article 6, paragraph 3, of the UNCITRAL Model Law on Electronic Signatures. That option is reflected in variant B of paragraph 3 of draft article 9. It should be noted these options are not mutually exclusive, since article 7, paragraph 1, of the Model Law on Electronic Commerce was the basis for the more detailed rules in article 6, paragraph 3, of the Model Law on Electronic Signatures.

19. Ultimately, the choice between the two variants involves a decision on the desirable level of detail in order to provide meaningful guidance and an acceptable level of uniformity. In any event, it seems important that the rules preserve the appropriate degree of flexibility so as to allow the parties and the courts to assess the adequacy and reliability of the authentication methods used in the light of all relevant circumstances.

20. In some countries, the courts have been inclined to interpret signature requirements liberally. Courts in the United States have been receptive to legislative recognition of electronic signatures, admitting their use also in situations not expressly contemplated in the enabling statute, such as in judicial warrants.<sup>20</sup> More

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<sup>18</sup> Landgericht Bonn, Case No. 2 O 450/00, 7 August 2001, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 136/2002 (available at [www.jurpc.de/rechtspr/20020136.htm](http://www.jurpc.de/rechtspr/20020136.htm), accessed on 25 August 2003).

<sup>19</sup> Oberlandesgericht Köln, Case No. 19 U 16/02, 19 April 2002, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 291/2002 (available at [www.jurpc.de/rechtspr/20020291.htm](http://www.jurpc.de/rechtspr/20020291.htm), accessed on 25 August 2003).

<sup>20</sup> *Department of Agriculture & Consumer Services v. Haire*, Court of Appeal of Florida, Case Nos. 4D02-2584 & 4D02-3315, 15 January 2003 (available at [www.4dca.org/Jan2003/01-15-03/4D02-2584op.pdf](http://www.4dca.org/Jan2003/01-15-03/4D02-2584op.pdf), accessed on 12 September 2003).



importantly for a contractual context, the courts have also assessed the adequacy of the identification in the light of the dealings between the parties, rather than using a strict standard for all situations. Thus, where the parties had regularly used e-mail in their negotiations, the courts have found that the originator's typed name in an e-mail satisfied statutory signature requirements.<sup>21</sup> A person's "deliberate choice to type his name at the conclusion of all e-mails" has been considered to be valid authentication.<sup>22</sup> A similarly liberal approach is taken by courts in Colombia that have confirmed the admissibility of judicial proceedings conducted entirely by electronic communications. The submissions exchanged during such proceedings were valid, even if they were not signed with a digital signature,<sup>23</sup> as the electronic communications used methods that allowed for the identification of the parties.<sup>24</sup>

21. However, in other countries, such as France, courts have been reluctant to accept electronic means of identification as equivalent to handwritten signatures prior to the adoption of legislation expressly recognizing the validity of electronic

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<sup>21</sup> *Cloud Corporation v. Hasbro, Inc.* involved a suit for breach of contract in which the defendant denied having placed a number of purchase orders. The parties had communicated through e-mail. It appeared that some of the correspondence exchanged contained no signature. The district court entered judgement in favour of the defendant for lack of proof of the alleged purchase commitments. The court of appeal reversed that judgement, holding that the sender's name on an e-mail satisfied the signature requirement of the statute of frauds. The court of appeal held further that neither common law nor the Uniform Commercial Code required a handwritten signature, "even though such a signature is better evidence of identity than a typed one". The purpose of the statute of frauds according to the court "is to prevent a contracting party from creating a triable issue concerning the terms of the contract—or for that matter concerning whether a contract even exists—on the basis of his say-so alone. That purpose does not require a handwritten signature, especially in a case in which there is other evidence, and not merely say-so evidence, of the existence of the contract besides the writings" (United States Court of Appeals for the Seventh Circuit, 26 December 2002, Federal Reporter, 3rd series, vol. 314, p. 296).

<sup>22</sup> *Jonathan P. Shattuck v. David K. Klotzbach*, Superior Court of Massachusetts, 11 December 2001, 2001 Mass. Super. LEXIS 642. In this case, the buyer filed an action to enforce a contract for the sale of real property and to recover damages arising out of an alleged breach of that contract against the sellers. The sellers filed a motion to dismiss alleging that there was no written and signed sales contract that met the form requirements of the laws of Massachusetts. The parties had negotiated the sale of real estate through the exchange of e-mails. All e-mail correspondence between the parties contained a typewritten signature at the end. The court held that the parties had formed an agreement as to the essential terms of the land sale contract: the parties, the locus, the nature of the transaction and the purchase price, satisfying the statute of frauds. Moreover, the court held that the e-mails sent by the seller regarding the terms of the sale of the property were intended to be authenticated by the seller's typed name at the closing of his mails.

<sup>23</sup> Colombia has adopted the UNCITRAL Model Law on Electronic Commerce. Although the law contains a general provision similar to article 7 of the Model Law, the law establishes a legal presumption of authenticity only in respect of digital signatures (*Ley Número 527 de 1999: Ley de comercio electrónico*, article 28).

<sup>24</sup> *Juan Carlos Samper v. Jaime Tapias*, Juzgado Segundo Promiscuo Municipal Rovira Tolima, 21 July 2003, Rad. 73-624-40-89-002-2003-053-00 (available at [www.alfaredi.org/documento/alexdiav.pdf](http://www.alfaredi.org/documento/alexdiav.pdf), accessed on 12 September 2003).

signatures.<sup>25</sup> At the same time, however, there are decisions that accept the electronic filing of administrative complaints for the purpose of meeting a statutory deadline, at least as long as they are subsequently confirmed by regular mail.<sup>26</sup>

22. In contrast to their restrictive approach to the attribution of data messages in the formation of contracts, German courts have been liberal in the acceptance of identification methods as equivalent to handwritten signatures in court proceedings. The debate in Germany has evolved around the increasing use of scanned images of legal counsel's signature to authenticate computer facsimiles containing statements of appeals transmitted directly from a computer station via modem to a court's facsimile machine. In earlier cases, courts of appeal<sup>27</sup> and the Federal Court (*Bundesgerichtshof*)<sup>28</sup> had held that a scanned image of a handwritten signature did not satisfy existing signature requirements and offered no proof of a person's identity. An identification might conceivably be attached to an "advance electronic signature", as defined in German law. Generally, however, it was for the legislator and not the courts to establish the conditions for the equivalence between writings and intangible communications transmitted by data transfers.<sup>29</sup> That understanding was eventually reversed in view of the unanimous opinion of the other high federal courts that accepted the delivery of certain procedural pleas by means of electronic communication of a data message accompanied by a scanned image of a signature.<sup>30</sup>

<sup>25</sup> The Cour de Cassation rejected the receivability of a statement of appeal signed electronically, because there were doubts as to the identity of the person who created the signature and the appeal had been signed electronically before entry into force of the law of 13 March 2000, which recognized the legal effect of electronic signatures (Cour de Cassation, Second Civil Chamber, 30 April 2003, *Société Chalets Boisson v. M. X.*, available at [www.juriscom.net/jpt/visu.php?ID=239](http://www.juriscom.net/jpt/visu.php?ID=239), accessed on 12 September 2003).

<sup>26</sup> Conseil d'État, 28 December 2001, N° 235784, *Élections municipales d'Entre-Deux-Monts* (available at [www.rajf.org/article.php3?id\\_article=467](http://www.rajf.org/article.php3?id_article=467), accessed on 12 September 2003).

<sup>27</sup> For instance, Oberlandesgericht Karlsruhe, Case No. 14 U 202/96, 14 November 1997, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 09/1998 (available at [www.jurpc.de/rechtspr/19980009.htm](http://www.jurpc.de/rechtspr/19980009.htm), accessed on 12 September 2003).

<sup>28</sup> Bundesgerichtshof, Case No. XI ZR 367/97, 29 September 1998, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 291/2002 (available at [www.jurpc.de/rechtspr/19990005.htm](http://www.jurpc.de/rechtspr/19990005.htm), accessed on 12 September 2003).

<sup>29</sup> The Bundesgerichtshof recognized that case law had for some time accepted the use of facsimile for transmission of pleas. In such cases, however, the original document had to be signed by hand by counsel and such signature usually appeared in the facsimile copy received by the courts. Facsimiles generated and transmitted directly by a computer, however, did not produce an original document in tangible form. Neither was the document signed by counsel by hand. Only the printout of the facsimile by the court's facsimile machine generated a tangible paper document. Accepting computer facsimiles would ultimately mean waiving the writing requirements created by statute. The legislator was called upon to establish the conditions for the equivalence between writings and intangible communications transmitted by data transfers. That result, in the view of the Bundesgerichtshof, could only be achieved by statute and not by case law (see note 28).

<sup>30</sup> In a decision on a case referred to it by the Bundesgerichtshof (see note 26 above), the Joint Chamber of the Highest Federal Courts of Germany (Gemeinsamer Senat der obersten Gerichtshöfe des Bundes) noted that form requirements in court proceedings were not an end in themselves. Their purpose was to ensure a sufficiently reliable ("*hinreichend zuverlässig*") determination of the content of the writing and the identity of the person from whom it

23. It is not suggested that the considerations that justify a liberal approach in the context of judicial or administrative appeals can be transposed directly to the context of international contracts. Indeed, while in a contractual context a party might be faced with the risk of repudiation of the agreement by the other party, in the context of civil proceedings it is typically the party using electronic signatures or records that is interested in confirming its approval of the record and its contents. Nevertheless, the above discussion shows how courts may be inclined in practice to assess the reliability of authentication methods in the light of the purposes for which they are used.

24. Another aspect that the Working Group may wish to bear in mind in its discussions is that under both article 7, paragraph 3, of the Model Law on Electronic Commerce and article 6, paragraph 5, of the Model Law on Electronic Signatures an enacting State has the possibility to exclude the recognition of electronic signatures in specific situations to be set forth in domestic legislation. Ideally, international legal harmonization would be best served by a commonly agreed list of exclusions. It is recognized, however, that such a result might not easily be achieved. One possible alternative, which the Working Group may wish to consider, might be to exclude only those situations where domestic laws either categorically exclude electronic signatures or where they prescribe the use of a particular type of electronic signature (“advanced signature” or “secure signature”).

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emanated. The Joint Chamber noted the evolution in the practical application of form requirements, so as to accommodate earlier technological developments, such as telex or facsimile. The Joint Chamber held that accepting the delivery of certain procedural pleas by means of electronic communication of a data message with a scanned image of a signature would be in line with the spirit of existing case law (Gemeinsamer Senat der obersten Gerichtshöfe des Bundes, GmS-OGB 1/98, 5 April 2000, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 160/2000 (available at [www.jurpc.de/rechtspr/20000160.htm](http://www.jurpc.de/rechtspr/20000160.htm), accessed on 12 September 2003).

**Note by the Secretariat on legal aspects of electronic commerce:  
electronic contracting: background information, working paper submitted  
to the Working Group on Electronic Commerce at its forty-second session**

ADDENDUM

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### III. Issues related to the use of data messages in international contracts

#### D. Automated information systems

1. Automated computer systems, sometimes called “electronic agents”, are being used increasingly in electronic commerce and have caused scholars, in particular in the United States of America, to revisit traditional common law theories of contract formation to assess their adequacy to contracts that come into being without human intervention.<sup>1</sup>

2. Existing uniform law conventions do not seem in any way to preclude the use of automated systems, for example, for issuing purchase orders or processing purchase applications. This seems to be the case in connection with the United Nations Convention on Contracts for the International Sale of Goods (“the United

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<sup>1</sup> See Anthony J. Bellia, Jr., “Contracting with electronic agents”, *Emory Law Journal*, vol. 50, fall 2001, p. 1047-1092.

Nations Sales Convention”),<sup>2</sup> which allows the parties to create their own rules,<sup>3</sup> for example, in an electronic data interchange (EDI) trading partner agreement regulating the use of “electronic agents”. The UNCITRAL Model Law on Electronic Commerce also lacks a specific rule on the matter. While nothing in the Model Law seems to create obstacles to the use of fully automated systems, it does not deal specifically with those systems, except for the general rule on attribution in article 13, paragraph 2 (b).<sup>4</sup>

### 1. Responsibility for automated information systems

3. In an early discussion of the matter, the Working Group was of the view that, while the expression “electronic agent” had been used for purposes of convenience, the analogy between an automated system and a sales agent was not appropriate. General principles of agency law (for example, principles involving limitation of liability as a result of the faulty behaviour of the agent) could not be used in connection with the operation of such systems. The Working Group was also of the view that, as a general principle, the person (whether a natural person or a legal entity) on whose behalf a computer was programmed should ultimately be responsible for any message generated by the machine (A/CN.9/484, paras. 106 and 107).

4. At present, the attribution of actions of automated information systems to a person or legal entity is based on the paradigm that an automated information system is capable of performing only within the technical structures of its preset programming. However, at least in theory it is conceivable that future generations of automated information systems may be created with the ability to act autonomously, and not just automatically. That is, through developments in artificial intelligence, a computer may be able to “learn through experience, modify the instructions in their own programs, and even devise new instructions”.<sup>5</sup> That possibility has led some commentators to go as far as to advocate the attribution of at least some elements of legal personality to automated computer systems<sup>6</sup> or to a transposition of the general theory of agency to computer transactions.<sup>7</sup> Other commentators, however, seem less inclined to impose liability upon machines and prefer to apply general principles of law, such as “reliance” and “good faith”, to establish the link between the computer and the person on whose behalf it functions.<sup>8</sup>

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<sup>2</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567, p. 3 (also available at [www.uncitral.org/english/texts/sales/CISG.htm](http://www.uncitral.org/english/texts/sales/CISG.htm)).

<sup>3</sup> United Nations Sales Convention, art. 9.

<sup>4</sup> Article 13, paragraph 2 (b), of the Model Law provides that, as between the originator and the addressee, a data message is deemed to be that of the originator if it was sent “by an information system programmed by, or on behalf of, the originator to operate automatically”.

<sup>5</sup> T. Allen and R. Widdison, “Can computers make contracts?”, *Harvard Journal of Law and Technology*, vol. 9, winter 1996, pp. 25-52.

<sup>6</sup> For instance, Lawrence B. Solum, “Legal personhood for artificial intelligences”, *North Carolina Law Review*, vol. 70, 1992, pp. 1231-1287; and Leon E. Wein, “The responsibility of intelligent artifacts: toward an automated jurisprudence”, *Harvard Journal of Law and Technology*, vol. 6, 1992, pp. 103-154.

<sup>7</sup> David D. Wong, “The emerging law of electronic agents: e-commerce and beyond”, *Suffolk University Law Review*, vol. 33, 1999, pp. 83-106.

<sup>8</sup> See Jean-François Lerouge, “The use of electronic agents questioned under contractual law: suggested solutions on a European and American level”, *John Marshall Journal of Computer*

5. Even if no modification appears to be needed in general rules of contract law, it might be useful for a new international instrument to make it clear that the actions of automated systems programmed and used by people will bind the user of the system, regardless of whether human review of a particular transaction has occurred.

## 2. Errors in messages and communications

6. Closely related to the use of automated computer systems is the question of mistakes and errors in electronic commerce. Such errors may be either the result of human actions (for example, typing errors) or the consequence of malfunctioning of the information system used.

### (a) *Human errors*

7. Since the Model Law is not concerned with substantive issues that arise in contract formation, it does not deal with the consequences of mistake and error in electronic contracting. However, recent uniform legislation enacting the Model Law, such as the Uniform Electronic Commerce Act of Canada (UECA) and the United States Uniform Electronic Transactions Act (UETA), contain provisions dealing with errors made by natural persons when dealing with an automated computer system of another person. The relevant provisions in UECA (sect. 22) and in UETA (sect. 10) set out the conditions under which a natural person is not bound by a contract in the event that the person made a material error.

8. The rationale for provisions such as those contained in UECA and in UETA seems to be the relatively higher risk that an error made in transactions involving a natural person, on the one hand, and an automated computer system, on the other, might not be noticed, as compared with transactions that involve only natural persons. Errors made by the natural person in such a situation may become irreversible once acceptance is dispatched.

9. In favour of formulating a substantive rule on the consequences of computer errors, it could be said that other international texts, such as the UNIDROIT Principles of International Commercial Contracts, deal with the consequences of errors for the validity of the contract, albeit restrictively (see arts. 3.5 and 3.6). However, a counter-argument could be that a provision of that type would interfere with well-established notions of contract law and might not be appropriate in the context of an instrument specifically concerned with electronic commerce, in view of the risk of duplication of legal regimes (see A/CN.9/WG.IV/WP.96, p. 4, and A/CN.9/WG.IV/WP.101, p. 3).

10. A slightly different approach might be to envisage only provisions that promote best business practices, such as provisions that would induce businesses to make available procedures for detecting and correcting errors in electronic contract negotiation, without dealing with the consequences of errors for the validity of the contract. Article 11, paragraph 2, of Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000<sup>9</sup> on certain legal aspects of information society services, in particular electronic commerce, in the internal

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*and Information Law*, vol. 18, winter 1999, pp. 403-433. Similarly, from a common law perspective, see C. C. Nicoll, "Can computers make contracts?", *The Journal of Business Law*, January 1998, p. 42.

market creates such an obligation for providers of “information society services”. It is recognized, however, that, in implementing the EU Directive, States have added various consequences for a party’s failure to provide procedures for detecting and correcting errors in electronic contract negotiation. For example, in Austria,<sup>10</sup> Ireland,<sup>11</sup> Italy<sup>12</sup> and Spain,<sup>13</sup> such failure constitutes an administrative offence and subjects the infringer to payment of a fine.<sup>14</sup> In Germany,<sup>15</sup> the consequence is an extension of the period within which a consumer may avoid a contract, which only begins to run from the time when the merchant has fulfilled its obligations. A similar consequence is provided in the United Kingdom of Great Britain and Northern Ireland, where the customer “shall be entitled to rescind the contract unless any court having jurisdiction in relation to the contract in question orders otherwise on the application of the service provider”.<sup>16</sup>

(b) *Errors generated by information systems*

11. Another issue that has been proposed for consideration by the United Nations Commission on International Trade Law (UNCITRAL) is whether a new international instrument should deal with errors made by the automated system itself. At its initial discussion of the issue, the UNCITRAL Working Group on Electronic Commerce was of the view that errors made by any such system should ultimately be attributable to the persons on whose behalf they operated. Nevertheless, the Working Group recognized that there might be circumstances that justified a mitigation of that principle, such as when an automated system generated erroneous messages in a manner that could not have reasonably been anticipated by the person on whose behalf the messages were sent. It was suggested that elements to be taken into account when considering possible limitations for the responsibility of the party on whose behalf the automated system was operated included the extent to which the party had control over the software or other technical aspects used in programming the system (A/CN.9/484, para. 108).

12. The complexity of the issues involved can be illustrated by three very similar cases where German courts arrived at opposing results.<sup>17</sup> The cases related to sales

<sup>9</sup> *Official Journal of the European Communities* No. L 17, 17 July 2000, pp. 1-16.

<sup>10</sup> *Bundesgesetz mit dem bestimmte rechtliche Aspekte des elektronischen Geschäfts- und Rechtsverkehrs geregelt (E-Commerce-Gesetz—ECG) und Änderung des Signaturgesetzes sowie der Zivilprozessordnung (Bundesgesetzblatt für die Republik Österreich, 2001, p. 1977), sect. 26, para. 4.*

<sup>11</sup> European Communities (Directive 2000/31/EC) Regulations 2003, regulation 13 (5).

<sup>12</sup> *Decreto legislativo 9 aprile 2003, n. 70, art. 21, para. 1.*

<sup>13</sup> *Ley 34/2002, de 11 de julio, de servicios de la sociedad de la información y de comercio electrónico, arts. 38 and 39.*

<sup>14</sup> *Bundesgesetz mit dem bestimmte rechtliche Aspekte des elektronischen Geschäfts- und Rechtsverkehrs geregelt (E-Commerce-Gesetz—ECG) und Änderung des Signaturgesetzes sowie der Zivilprozessordnung (Bundesgesetzblatt für die Republik Österreich, 2001, p. 1977), sect. 26, para. 4.*

<sup>15</sup> *Bürgerliches Gesetzbuch, sect. 312e, para. 1, first sentence.*

<sup>16</sup> Electronic Commerce (EC Directive) Regulations 2002 (Statutory Instrument 2002 No. 2013), regulation 15.

<sup>17</sup> Oberlandesgericht Frankfurt, 20 November 2002, *JurPC—Internet Zeitschrift für Rechtsinformatik*, *JurPC WebDok 91/2003* ([www.jurpc.de/rechtspr/20030091.htm](http://www.jurpc.de/rechtspr/20030091.htm)); Landgericht Köln, 16 April 2003, *JurPC—Internet Zeitschrift für Rechtsinformatik*, *JurPC WebDok 138/2003* ([www.jurpc.de/rechtspr/20030138.htm](http://www.jurpc.de/rechtspr/20030138.htm)); and Amtsgericht Westerburg, Case

of goods erroneously offered over the Internet for a price below the price intended by the seller. They all involved interactive applications that generated automatic replies from the seller stating that the customer's "order" (*Auftrag*) would be immediately "carried out" (*ausgeführt*). It was surmised that the errors were computer-made and had occurred during processing and posting of the seller's information on web sites maintained by independent Internet service providers. The courts affirmed the principle that automated communications were attributable to the persons on whose behalf the system had been programmed and in whose names the messages were sent. The courts consistently regarded the advertisement of goods via the Internet as a mere invitation to treat (*invitatio ad offerendum*) and considered that a binding contract would only come into being once the seller had accepted the buyer's bid (offer). The courts further affirmed the legal value of the messages sent by the automatic reply function as binding expressions of intention (*Willenserklärung*) and valid acceptances for purposes of contract formation.

13. Nevertheless, one court of appeals found that the pricing error in the Internet advertisement vitiated the seller's acceptance and rendered it invalid.<sup>18</sup> Two district courts, in turn, regarded the invitation to treat expressed through the Internet advertisement as a separate legal act from the eventual acceptance of the buyer's offer, so that the error in the first instance did not affect the validity of the seller's acceptance.<sup>19</sup> While some factual differences between the cases might have influenced their outcome,<sup>20</sup> the discrepancy between the judgements seems to result from conflicting views regarding the allocation of risks for malfunctioning of commercial web sites.

## E. Incorporation and availability of contract terms

14. One additional question concerning contract formation through the intervention, in whole or in part, of automated information systems is the legal effect of the incorporation by reference of contractual clauses accessible through a "hypertext link". Another issue relates to the availability and retention or reproduction of contract terms.

### 1. Incorporation of terms and conflicting contract terms

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No. 21 C 26/03, 14 March 2003, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 184/2003 ([www.jurpc.de/rechtspr/20030184.htm](http://www.jurpc.de/rechtspr/20030184.htm)). All accessed on 9 September 2003.

<sup>18</sup> Oberlandesgericht Frankfurt: "Die unrichtige Übermittlung der 'invitatio ad offerendum' wirkte bei der infolge der entsprechenden Programmierung automatisch erstellten und dann an den Rechner des Klägers elektronisch übermittelten Annahmeerklärung der Beklagten noch fort." ([www.jurpc.de/rechtspr/20030091.htm](http://www.jurpc.de/rechtspr/20030091.htm)).

<sup>19</sup> Landgericht Köln: "Eine auf diesen Irrtum gestützte Anfechtung kommt gleichwohl nicht in Betracht, weil der Irrtum nach dem klägerischen Sachvortrag allenfalls bei der Einstellung der Preisangaben ins Internet, nicht aber zum massgeblichen Zeitpunkt der Abgabe der Willenserklärung vorgelegen hat." ([www.jurpc.de/rechtspr/20030138.htm](http://www.jurpc.de/rechtspr/20030138.htm)). Similarly, Amtsgericht Westerbürg ([www.jurpc.de/rechtspr/20030184.htm](http://www.jurpc.de/rechtspr/20030184.htm)).

<sup>20</sup> Such as the fact that in the Frankfurt case the erroneously advertised price represented 1 per cent of the ordinary value of the product, whereas in the Cologne case the court found that the price, which arguably fell some 50 per cent below the ordinary market price, was not extraordinary (keine Seltenheit) for an Internet sale.



15. The question of incorporation of contract terms is dealt with in article 5 bis of the Model Law. That provision sets out the general rule that information shall not be denied validity or enforceability solely because it has been incorporated by reference. Domestic laws typically go beyond that general rule and set down the substantive conditions for the enforceability of terms incorporated by reference. In doing so, it seems that courts make a distinction between terms formulated by one party, which seeks to enforce them against the other party, and terms established by a third party and intended to apply to all transactions being negotiated in a particular market or through a particular facility offered by such third party. In the first situation, courts in many legal systems seem not to automatically assume a party's acceptance of the terms incorporated by reference. Courts have in fact required a specific act of incorporation and held that the mere existence of such terms in an easily accessible resource (such as a party's web site) was not sufficient to effectively incorporate those terms into a contract in which they were not otherwise referred to.<sup>21</sup> The courts do not seem to have categorically excluded the possibility of incorporating terms by the mere clicking of an "I agree" button on a computer screen.<sup>22</sup> Yet, courts have often required unambiguous demonstration that the accepting party either had an opportunity to actually access and read those terms or that the party was adequately alerted, through a conspicuously placed notice or otherwise, of the existence of those terms and their relevance for the transaction in question.<sup>23</sup>

16. In some legal systems, courts seem to establish a distinction between contractual terms developed by one of the parties and contract terms developed by another entity (a third party) that offers the electronic platform for the parties to conduct their negotiations. This question has arisen, for instance, in connection with Internet auctions in Germany. In an early case, a district court in Germany found that a person offering goods through an Internet auction platform had not made a binding offer, but had merely invited offers in respect of the goods during a set period of time.<sup>24</sup> The fact that the general conditions of the operator of the auction platform qualified the offer of goods for auction as "binding and irrevocable" was not regarded as being controlling. That decision was later reversed by the court of appeal, which found that there was no need for the parties to specifically refer to or

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<sup>21</sup> Hanseatisches Oberlandesgericht Hamburg, Case No. 3 U 168/00, 13 June 2002, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 288/2002 (available at [www.jurpc.de/rechtspr/20020288.htm](http://www.jurpc.de/rechtspr/20020288.htm), accessed on 1 September 2003).

<sup>22</sup> See *Lawrence Groff v. America Online, Inc.*, Superior Court of Rhode Island, 27 May 1998, LEXIS 46 (R.I. Super., 1998) (available at <http://legal.web.aol.com/decisions/dlither/groff.html>, accessed on 3 September 2003); *Hotmail Corp. v. Van\$ Money Pie*, United States District Court for the Northern District of California, 16 April 1998, U.S. Dist. LEXIS 10729 (U.S. Dist., 1998); *Steven J. Caspi et al. v. The Microsoft Network, L.L.C., et al.*, Superior Court of New Jersey, Appellate Division, 2 July 1999 (New Jersey Superior Court Reports, vol. 323, p. 118); and *I. Lan Systems, Inc. v. Netscout Service Level Corp.*, United States District Court, District of Massachusetts, 2 January 2002 (Federal Supplement, 2nd series, vol. 183, p. 328).

<sup>23</sup> For instance, *Specht v. Netscape Communications Corp.*, Federal Supplement, 2nd series, vol. 150, p. 585, affirmed in *Specht v. Netscape Communications Corporation and America Online, Inc.*, United States Court of Appeals for the Second Circuit, 1 October 2002, Federal Reporter, 3rd series, vol. 306, p. 17.

<sup>24</sup> Landgericht Münster, 21 January 2000, Case No. 4 O 424/99, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 60/2000 (available at [www.jurpc.de/rechtspr/20000060.htm](http://www.jurpc.de/rechtspr/20000060.htm), accessed on 1 September 2003).

otherwise incorporate into their communications the general conditions of the operator of the auction platform, which highlighted the binding character of offers of goods for auction. Both parties should be deemed to have accepted those general conditions beforehand.<sup>25</sup> This understanding has been followed by other courts<sup>26</sup> and was also affirmed by the Federal Court (*Bundesgerichtshof*), which held that the seller could have avoided, if it had wished, the impression of being bound by its offer by introducing an appropriate statement in its automatic reply messages. However, a reservation to the general conditions that was not recognizable as such by the addressees of the offer could not be held against them.<sup>27</sup>

17. Another question concerning contract formation through automated information systems is the legal effect of contract terms displayed on a video screen but not necessarily expected by a party. Directly related to this question is the issue of the “battle of the forms”, which may be a serious problem in the context of electronic transactions, in particular where fully automated systems are used and no means are provided for reconciling conflicting contractual terms.

18. Neither of these issues is dealt with in article 5 bis of the Model Law, which only contains a general provision intended to uphold the legal effect of information incorporated by reference. Furthermore, neither the Model Law nor the United Nations Sales Convention expressly provide a solution for the well-known problem of “battle of the forms”.<sup>28</sup> The magnitude of the problem and the profound differences, both in policy and approach, in the manner in which those issues are addressed under domestic laws<sup>29</sup> suggest that there would be significant obstacles for international harmonization.

## 2. Availability of contract terms

19. Except for purely oral transactions, most contracts negotiated through traditional means result in some tangible record of the transaction to which the parties can refer in case of doubt or dispute. In electronic contracting, such a record, which may exist as a data message, may only be temporarily retained or may be available only to the party through whose information system the contract was concluded. Thus, some recent legislation on electronic commerce, such as the EU Directive, requires that a person offering goods or services through information systems accessible to the public should provide means for storage or printing of the contract terms.

<sup>25</sup> Oberlandesgericht Hamm, 14 December 2000, Case No. 2 U 58/00, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 255/2000 (available at [www.jurpc.de/rechtspr/20000255.htm](http://www.jurpc.de/rechtspr/20000255.htm), accessed on 1 September 2003).

<sup>26</sup> Amtsgericht Hannover, 7 September 2002, Case No. 501 C 1510/01, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 299/2002 (available at [www.jurpc.de/rechtspr/20020299.htm](http://www.jurpc.de/rechtspr/20020299.htm), accessed on 1 September 2003).

<sup>27</sup> Bundesgerichtshof, 7 November 2001, Case No. VIII ZR 13/01, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 255/2001 (available at [www.jurpc.de/rechtspr/20010255.htm](http://www.jurpc.de/rechtspr/20010255.htm), accessed on 1 September 2003).

<sup>28</sup> The United Nations Sales Convention offers an implicit solution for the question in article 19, paragraph 2. Specific rules on the matter can be found in the UNIDROIT Principles of International Commercial Contracts (Unidroit, Rome, 1994).

<sup>29</sup> An overview of the differences between American and European law can be found in James R. Maxeiner, “Standard terms contracting in the global electronic age: European alternatives”, *Yale Journal of International Law*, vol. 28, No. 1 (winter 2003), pp. 109-182.

20. The rationale for creating such specific obligations seems to be an interest in enhancing legal certainty, transparency and predictability in international transactions concluded by electronic means. Thus, it may not be unreasonable to require certain information to be provided or technical means to be offered in order to make available contract terms in a way that allows for their storage and reproduction, in the absence of a prior agreement between the parties, such as a trading partner agreement or other type of agreement.

21. No similar obligations exist under the United Nations Sales Convention or most international instruments dealing with commercial contracts. The Working Group has been faced with the question of whether, as a matter of principle, it should propose specific obligations for parties conducting business electronically that may not exist when they contract through more traditional means. One objection to the inclusion of disclosure obligations in a new international uniform law instrument has been that the consequences of a party failing to comply with any such obligation would have to be considered and well defined (see A/CN.9/WG.IV/WP.96, annex, p. 6).

22. The views within the Working Group are thus far divided between two groups. One view is that obligations to disclose certain information should be left for international industry standards or guidelines or, at the national level, for regulatory regimes governing the provision of online services, especially under consumer protection regulations, but should not be included in an international convention dealing with electronic contracting (A/CN.9/509, para. 63). The other view is that disclosure obligations of certain basic information about a business entity would promote good business practices and enhance confidence in electronic commerce (A/CN.9/509, para. 64).

23. The experience with the EU Directive does not prescribe what the consequences are if “information society services” fail to comply with its provisions on this point. In the absence of uniform sanctions, EU member States have provided a variety of different consequences in their national laws.<sup>30</sup> The laws of Austria,<sup>31</sup> Ireland,<sup>32</sup> Italy<sup>33</sup> and Spain,<sup>34</sup> for example, provide that failure to make the contract terms available constitutes an administrative offence and subject the infringer to payment of a fine.<sup>35</sup> In the United Kingdom, the law distinguishes between disclosure of information and availability of contract terms. In the first case, those duties “shall be enforceable, at the suit of any recipient of a service, by an action

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<sup>30</sup> This has been one of the arguments put forward by the International Chamber of Commerce in its criticism of the corresponding provision in the preliminary draft convention (A/CN.9/WG.IV/WP.101, p. 6).

<sup>31</sup> *Bundesgesetz mit dem bestimmte rechtliche Aspekte des elektronischen Geschäfts- und Rechtsverkehrs geregelt (E-Commerce-Gesetz—ECG) und Änderung des Signaturgesetzes sowie der Zivilprozessordnung (Bundesgesetzblatt für die Republik Österreich, 2001, p. 1977)*, sect. 26, para. 4.

<sup>32</sup> European Communities (Directive 2000/31/EC) Regulations 2003, regulation 7 (2).

<sup>33</sup> *Decreto legislativo 9 aprile 2003, n. 70*, art. 21, para. 1.

<sup>34</sup> *Ley 34/2002, de 11 de julio, de servicios de la sociedad de la información y de comercio electrónico*, arts. 38 and 39.

<sup>35</sup> *Bundesgesetz mit dem bestimmte rechtliche Aspekte des elektronischen Geschäfts- und Rechtsverkehrs geregelt (E-Commerce-Gesetz—ECG) und Änderung des Signaturgesetzes sowie der Zivilprozessordnung (Bundesgesetzblatt für die Republik Österreich, 2001, p. 1977)*, sect. 26, para. 4.

against the service provider for damages for breach of statutory duty”.<sup>36</sup> In the second case, the customer “may seek an order from any court having jurisdiction in relation to the contract requiring that service provider to comply with that requirement”.<sup>37</sup> In Germany, the consequence is an extension of the period within which a consumer may avoid the contract, which does not begin to run until the time when the merchant has complied with its obligations.<sup>38</sup> In most cases, these sanctions do not exclude other consequences that may be provided in law, such as sanctions under fair competition laws.<sup>39</sup>

24. The Working Group may wish to consider whether the preliminary draft convention should include a uniform regime of consequences for failure to comply with draft article 15 and, if so, what kind of consequences might be appropriate. Arguably, rendering commercial contracts invalid for failure to comply with disclosure obligations may be an unprecedented solution for an UNCITRAL text, as other texts, such as the United Nations Sales Convention, have not dealt with the validity of contracts. On the other hand, providing for other types of sanction, such as tort liability or administrative sanctions, would probably be outside the scope of the work that UNCITRAL has thus far done. One alternative that the Working Group may wish to explore might be rules that limit a party’s right to rely on or enforce contract terms that have not been made available to the other party in accordance with draft article 15.

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<sup>36</sup> Electronic Commerce (EC Directive) Regulations 2002 (Statutory Instrument 2002 No. 2013), sect. 11 (2), regulation 13.

<sup>37</sup> Electronic Commerce (EC Directive) Regulations 2002 (Statutory Instrument 2002 No. 2013), sect. 11 (2), regulation 14.

<sup>38</sup> *Bürgerliches Gesetzbuch*, sect. 312e, para. 1, first sentence.

<sup>39</sup> German courts have decided, for example, that failure by a company to disclose its name and address, as required under the German Distance Sales Law (*Fernabsatzgesetz*), which is based largely on a directive of the European Commission, represented an act of unfair competition against which the violator’s competitors could seek an injunction (Oberlandesgericht Frankfurt, Case No. 6 W 37/01, 17 April 2001, *JurPC—Internet Zeitschrift für Rechtsinformatik*, JurPC WebDok 135/2001 ([www.jurpc.de/rechtspr/20010135.htm](http://www.jurpc.de/rechtspr/20010135.htm))).

**D. Working paper on legal aspects of electronic commerce: electronic contracting: provisions for a draft convention: comments by the International Chamber of Commerce, submitted to the Working Group on Electronic Commerce at its forty-second session  
(A/CN.9/WG.IV/WP.105) [Original English]**

The Secretariat has received comments on the Working's Group's consideration of a possible new international instrument on electronic contracting by a task force established by the International Chamber of Commerce. The text of those comments is reproduced in the annex to this note in the form in which it was received by the Secretariat.

**ANNEX**

**ICC E-terms 2004 and UNCITRAL**

**1. Introduction**

The International Chamber of Commerce (ICC) is grateful to UNCITRAL for the invitation to provide views regarding current UNCITRAL proposals for the legal framework for electronic contracting.

At the latest UNCITRAL Working Group IV Session that took place in New York from 5-9 May 2003, ICC submitted to UNCITRAL a statement that ICC will draft a self-regulatory legal instrument based on an assessment of business' practices and needs in relation to their electronic contracting. ICC's proposal is available as UN Document A/CN.9/WG.IV/WP.101.

This document outlines the latest developments and progress ICC has made since the May 2003 Session. ICC looks forward to reporting in greater detail to the UNCITRAL Working Group at its next Session that takes place from 17-21 November in Vienna.

**2. ICC Task Force on Electronic Contracting**

In order to focus the work appropriately, ICC has created a Task Force on Electronic Contracting. The task force is co-chaired by:

→ **Professor Charles Debattista** (UK), Professor of Commercial Law, University of Southampton; and chair of ICC Task Force on Incoterms

→ **Christopher Kuner** (Belgium), Partner, Hunton & Williams; and chair of ICC Task Force on International Harmonization Efforts

Members of the task force includes experts from companies of all sizes, sectors and many countries from all parts of the world, a few of which include Canada, China, France, Germany, Mexico, Sweden, Switzerland, Syria, Venezuela and UK.

The Task Force is a joint initiative between two ICC Commissions, namely the ICC Commission on Commercial Law and Practice (CLP), and ICC Commission on E-Business, IT and Telecoms (EBITT).

### **3. ICC E-terms 2004**

The ICC Task Force on Electronic Contracting has started drafting ICC's instrument called E-terms 2004. The draft will be circulated to ICC members and national committees in more than 130 countries by the end of September. E-terms 2004 is expected to be finalized and adopted by ICC's Executive Board in the first half of 2004. The Draft E-terms 2004 will be presented in greater detail at the next UNCITRAL WG IV Session that takes place from 17-21 November 2003 in Vienna.

ICC E-terms 2004 will be focused and pragmatic, reflect practical problems and solutions, and take into account the different needs of large and small companies. E-terms 2004 will be a voluntary instrument not conflicting with party autonomy. The scope of E-terms 2004 is based on a careful assessment of the practices and needs of companies of various sectors and sizes. E-terms 2004 will consist of model clauses and a guidance document.

ICC E-terms 2004 has been received with great interest from the press, and has been the subject of a number of articles including *Legal Times*, 21 July 2003 "Clearing up e-contracting issues", and the cover story of *Washington Internet Daily*, 25 August 2003 "Industry Group Urges Self-Regulation of E-Contracts".

ICC looks forward to presenting E-terms 2004 to the members of UNCITRAL Working Group IV in November 2003, and working with UNCITRAL on these most important issues for global business.

**E. Working paper on legal aspects of electronic commerce: electronic contracting: provisions for a draft convention: comments by the World Intellectual Property Organization, submitted to the Working Group on Electronic Commerce at its forty-second session**

**(A/CN.9/WG.IV/WP.106) [Original English]**

1. Pursuant to a request by the Working Group, at its forty-first session (A/CN.9/528, para. 58), the Secretariat has sought the views of the International Bureau of the World Intellectual Property Organization (WIPO) as to whether, in the view of WIPO, the inclusion of contracts that involve licensing of intellectual property rights in the scope of the preliminary draft convention being considered by the Working Group, so as to expressly recognize the use of data messages in the context of those contracts, might in any way negatively interfere with established rules on the protection of intellectual property rights.
2. On 7 October 2003, the Secretariat received the following reply by the Office of Strategic Planning and Policy Development of the WIPO International Bureau:

“The International Bureau of WIPO thanks the secretariat of UNCITRAL for giving us an opportunity to review the preliminary draft convention on electronic contracting. The legal experts within the International Bureau of WIPO have reviewed the draft and see no need for an exclusion clause with regard to contracts involving IP rights. The International Bureau of WIPO has no further comments on the draft at this stage. However, we would appreciate it if the secretariat of UNCITRAL could send the relevant documents and the report on the international instrument to us so that we may give further comments, if any, on a revised draft in future.”

**F. Report of the Working Group on Electronic Commerce on the  
work of its forty-third session (New York, 15-19 March 2004)**

**(A/CN.9/548) [Original: English]**

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## **I. Introduction**

1. At its thirty-fourth session (Vienna, 25 June-13 July 2001), the United Nations Commission on International Trade Law (UNCITRAL) endorsed a set of recommendations for future work that had been made by the Working Group on Electronic Commerce at its thirty-eighth session, held in New York from 12 to 23 March 2001. They included, among other topics, the preparation of an international instrument dealing with selected issues on electronic contracting and a comprehensive survey of possible legal barriers to the development of electronic commerce in international instruments.

2. The deliberations of the Working Group on those topics began at its thirty-ninth session, held in New York from 11 to 15 March 2002, when the Working Group considered a note by the Secretariat that contained an initial draft, tentatively entitled "Preliminary draft convention on [international] contracts concluded or evidenced by data messages" (A/CN.9/WG.IV/WP.95, annex I). The deliberations of the Working Group are reflected in the report on the work of its thirty-ninth session



(A/CN.9/509). The Working Group resumed its consideration of the preliminary draft convention at its fortieth session, held in Vienna from 14 to 18 October 2002, when it concluded its initial review of the text (A/CN.9/527, paras. 72-126). The Working Group requested the Secretariat to prepare a revised version of the preliminary draft convention for consideration by the Working Group at its forty-first session. The Working Group considered the revised version of the preliminary draft convention (A/CN.9/WG.IV/WP.100) at its forty-first session, held in New York from 5 to 9 May 2003, when it reviewed articles 1-11 (A/CN.9/528, paras. 26-151). The Secretariat was requested to prepare a further revised version of the preliminary draft for consideration by the Working Group at its forty-second session.

3. A more detailed summary of the deliberations of the Working Group during those sessions is contained in the report of the Working Group on the work of its forty-second session, held in Vienna from 17 to 21 November 2003 (A/CN.9/546, paras. 1-24). At its forty-second session, the Working Group considered the newly revised text of the preliminary draft convention (A/CN.9/WG.IV/WP.103, annex). The Working Group reviewed articles 8-15 and requested a number of changes in connection therewith (A/CN.9/546, paras. 39-135).

## II. Organization of the session

4. The Working Group on Electronic Commerce, composed of all States members of the Commission, held its forty-third session in New York, from 15 to 19 March 2004. The session was attended by representatives of the following States members of the Working Group: Austria, Brazil, Cameroon, Canada, China, Colombia, Fiji, France, Germany, Honduras, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Mexico, Morocco, Russian Federation, Singapore, Spain, Sudan, Sweden, Uganda and United States of America.

5. The session was attended by observers from the following States: Belarus, Belgium, Botswana, Cuba, Czech Republic, Denmark, Finland, Ghana, Indonesia, Iraq, Ireland, Kuwait, Lesotho, Libyan Arab Jamahiriya, Madagascar, Mongolia, New Zealand, Peru, Philippines, Poland, Qatar, Republic of Korea, Saudi Arabia, Senegal, Serbia and Montenegro, Syrian Arab Republic, Thailand, Turkey, United Republic of Tanzania, Venezuela and Viet Nam.

6. The session was also attended by the Holy See as a non-member State maintaining a permanent observer mission at United Nations Headquarters.

7. Representatives of the following organizations of the United Nations system and other international organizations attended the session as observers: Economic Commission for Europe, World Bank, World Intellectual Property Organization, Asian-African Legal Consultative Organization, Commonwealth Secretariat, European Commission and the Interparliamentary Assembly of Member Nations of the Commonwealth of Independent States.

8. The following non-governmental organizations were invited by the Commission to attend the session as observers: American Bar Association, Association of the Bar of the City of New York, Center for International Legal Studies, European Law Students' Association, International Chamber of Commerce, International Law Institute, International Union of Latin Notaries and Union internationale des avocats.

9. The Working Group elected the following officers:  
Chairman: Jeffrey Chan Wah Teck (Singapore);  
Rapporteur: Ligia Claudia González Lozano (Mexico).
10. The Working Group had before it a newly revised version of the preliminary draft convention, which reflected the deliberations of the Working Group at its forty-second session (A/CN.9/WG.IV/WP.108, annex).
11. The Working Group adopted the following agenda:
  1. Opening of the session.
  2. Election of officers.
  3. Adoption of the agenda.
  4. Electronic contracting: provisions for a draft convention.
  5. Other business.
  6. Adoption of the report.

### **III. Summary of deliberations and decisions**

12. The Working Group resumed its deliberations on the newly revised preliminary draft convention contained in the annex to the note by the Secretariat (A/CN.9/WG.IV/WP.108). The decisions and deliberations of the Working Group with respect to the draft convention are reflected in chapter IV. The Secretariat was requested to prepare a revised version of the preliminary draft convention based on those deliberations and decisions for consideration by the Working Group at its forty-fourth session, tentatively scheduled to take place in Vienna from 18 to 22 October 2004.

13. The Working Group held a general discussion on draft articles 5 to 7 bis. The Working Group considered comments which anticipated positions that might be adopted by delegations on the understanding that such comments had no effect on the draft text, which will be formally examined at the forty-fourth session of the Working Group. The Working Group agreed that it should endeavour to complete its work on the draft convention with a view to enabling its review and approval by the Commission in 2005.

### **IV. Electronic contracting: provisions for a draft convention**

#### **Article 14 [16]. Error in electronic communications**

14. The text of draft article 14 [16] was as follows:

## “Variant A

“[Unless otherwise [expressly] agreed by the parties,] a contract concluded by a person that accesses an automated information system of another party has no legal effect and is not enforceable if the person made an error in a data message and:

“(a) The automated information system did not provide the person with an opportunity to prevent or correct the error;

“(b) The person notifies the other party of the error as soon as practicable when the person making the error learns of it and indicates that he or she made an error in the data message;

“[(c) The person takes reasonable steps, including steps that conform to the other party’s instructions, to return the goods or services received, if any, as a result of the error or, if instructed to do so, to destroy such goods or services; and

“[(d) The person has not used or received any material benefit or value from the goods or services, if any, received from the other party.]

## “Variant B

“1. [Unless otherwise [expressly] agreed by the parties,] a contract concluded by a person that accesses an automated information system of another party has no legal effect and is not enforceable if the person made an error in a data message and the automated information system did not provide the person with an opportunity to prevent or correct the error. The person invoking the error must notify the other party of the error as soon as practicable and indicate that he or she made an error in the data message.

“[2. A person is not entitled to invoke an error under paragraph 1:

“(a) If the person fails to take reasonable steps, including steps that conform to the other party’s instructions, to return the goods or services received, if any, as a result of the error or, if instructed to do so, to destroy such goods or services; or

“(b) If the person has used or received any material benefit or value from the goods or services, if any, received from the other party.]”

15. A widely shared and strongly supported view was that the draft article should be deleted, as it dealt with substantive matters of contract law that the draft convention should not address. It was stated that errors between individuals and automated information systems were not substantially different from errors made in traditional means of communication, so that no special rules were needed or advisable. Problems that might arise in an electronic environment should not be solved by the draft convention and should instead be governed by the applicable law. Concern was also expressed about the possible impact of the draft article on any existing laws on error. While the initial version of the draft article (A/CN.9/WG.IV/WP.95, annex I) was only concerned with ensuring the availability of means to correct errors in messages exchanged with automated information systems, the current version deprived the entire contract of its validity, a result that might not be provided for under domestic law.

16. Another argument against retaining the draft article was that the provision might interfere with the operation of financial systems, stock markets or commodity trades if the parties were allowed to later withdraw from their offers or bids on the basis that they had been the result of a mistake. Legal uncertainty in those time-critical markets required that parties should be bound even if they acted unintentionally. The draft article, it was stated, was more appropriate for consumer protection than for the practical requirements of commercial transactions. Furthermore, the draft article, by focusing on automated information systems, was not technology-neutral, being thus inconsistent with one of the basic principles of the UNCITRAL Model Law on Electronic Commerce.<sup>1</sup> All that was needed in connection with such systems was a positive rule affirming their use in the context of contract formation, but not a substantive rule dealing with errors in automated transactions.

17. The countervailing view, which also gained broad and strong support, was that the draft article contained useful provisions to deal with particular problems that arose in electronic commerce. There was a need for such a provision in the light of the relatively higher risk of human errors, such as keystroke errors, being made in transactions made through automated information systems than in more traditional modes of contract negotiation. For example, while it would be unlikely for a person to deliver documents unintentionally to a post office, in practice there were precedents where persons had claimed not to have intended to confirm a contract by hitting "Enter" on a computer keyboard or clicking on an "I agree" icon on a computer screen. Thus, the draft article was not intended to be media-neutral; on the contrary, it was intended to deal with a specific issue affecting certain forms of electronic communications. However, in doing so, the draft article did not overrule existing law on error, but merely offered a meaningful addition to it by focusing on the importance of providing means of having the error corrected.

18. It was pointed out that the contract law of some legal systems confirmed the need for the draft article. That was the case, for example, in connection with rules that required a party seeking to avoid the consequences of an error to show that the other party knew or ought to have known that a mistake had been made. While there were means of providing such proof if there was an individual at each end of the transaction, awareness of the mistake was almost impossible to demonstrate when there was an automated process at the other end.

19. However, most expressions of support for the principles underlying the draft article also emphasized the need for reformulating it so as to define more narrowly its scope of application and its operative provisions. The draft article, it was suggested, should be circumscribed to errors that occurred in interactions between individuals and automated information systems that did not offer the individual an opportunity to review or correct the errors. Rather than requiring generally that an opportunity to correct errors should be provided, the draft article should limit itself to providing consequences for the absence of such a possibility. Those consequences, it was further suggested, should be concerned only with avoiding the effects of errors contained in a data message and should not automatically affect the validity of the contract.

20. It was suggested that the draft article could provide, for example, that in a transaction involving an individual and an automated information system, the individual might avoid the effect of an unintended action of that individual that

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<sup>1</sup> United Nations publication, Sales No. E.99.V.4.

resulted from an error made by the individual in dealing with the automated information system of another person if that system did not provide an opportunity for the correction of that error. Such a provision might be further subject to the remaining conditions set out in subparagraphs (b) to (d) of variant A of the draft article and might be complemented with a provision to the effect that, if the conditions set forth in the draft article were not met, the consequences of the error would be as provided for by other laws, including the law on error, and by any agreement between the parties.

21. The proposals to reformulate the draft article so as to narrow its scope of application and limit the consequences contemplated by it were welcomed by the Working Group. Nevertheless, several comments emphasized the view that the preferable alternative should be simply to delete the draft article rather than to attempt to reformulate it.

22. Questions were raised concerning the proposed focus on actions taken by individuals and on the right of the individual to correct any errors made in communications with automated information systems. The question was asked whether it would be appropriate to limit a provision on errors only to errors committed by individuals, since errors might also occur in communications initiated by automated information systems. Furthermore, it was stated that it would be problematic to introduce the notion of “individual”, since any contract negotiated through automated information systems would ultimately be attributable to the legal entity that such an individual would represent. Any new version of the draft article should make it clear that the right to correct the mistake was not a right of the individual but of the party or legal entity on whose behalf the individual was acting. Lastly, if the draft article was retained, the Working Group should consider whether the provision should also deal with electronic mails sent by mistake, since there was no reason for limiting the provision only to communications with automated systems.

23. Criticism was also voiced on the basis that the proposed new version would retain parts of the draft article that conflicted with the existing law on error in some legal systems. That was the case, in particular, with respect to subparagraphs (c) and (d) of variant A, since some legal systems did not subject a person’s right to avoid a contract that was vitiated by mistake to the types of condition set forth in those provisions. Also, if the draft article was retained, it should make it clear that it dealt with unintentional acts, but not with other types of error that might occur, for example, when the sending party was unconscious at the point of sending.

24. Furthermore, it was stated that the notion of avoiding the consequences of an act might not be understood in the same manner in different legal systems. In some legal systems, for example, that notion would inevitably be interpreted as referring to the validity of an act and lead to discussions as to whether the act was null and void or voidable at the party’s request. One alternative solution might be to focus on a party’s ability to rely on a data message erroneously transmitted or drafted or to provide that a message that resulted from an error could not be invoked against the person who committed the error, if that person had not had an opportunity to review the message and correct the error. In response, it was stated that the proposed shift in approach should be carefully considered in the light, for instance, of subparagraphs (c) and (d) in variant A, which indicated that in some cases, goods or services might have been provided in reliance on the error. The party receiving the message should be able to rely on the message, despite the error, up to the point of receiving a notice of error.

25. Another alternative suggestion was to recast the draft article as a presumption according to which, save for proof to the contrary, a statement that a person had acted in error in dealing with an automated system would be presumed to be true if the automated information system did not provide a method to correct the error. Such a presumption would leave it for the domestic law to determine the consequences of the alleged error on the contract and the remedies of the parties in that connection. With the same intention of avoiding interference with any domestic law on error, it was also proposed that the draft article should elaborate on the distinction between the effects of the error and the right to correct or withdraw the error. If the rule was expressed in terms of nullifying or avoiding or having an impact on the consequences of the error, it would invade the sphere of domestic laws on error. Instead, the draft article should provide for the right—unconditional or subject to specific conditions—of the individual, or the party on whose behalf the individual acted, exceptionally to withdraw the erroneous statement.

26. The Working Group considered at length the various views that were expressed and the different alternative approaches to the draft article proposed. The prevailing view within the Working Group was that, despite the strong expressions of support for the deletion of the provision, the draft article deserved to be retained, in a revised form, for further consideration. The Secretariat was requested to reformulate the draft article in a manner that removed the focus from the notion of avoidance of a contract or the effects of a data message and focused instead on providing the person in error with an opportunity to correct the error or to withdraw from its manifestation of intent, possibly subject to further conditions on the basis of subparagraphs (b), (c) and (d) of variant A. An additional provision might be included to the effect that the general law on error was not otherwise affected.

### **[Article X. Declarations on exclusions]**

27. The text of draft article X was as follows:

“[1. Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will not be bound by paragraph 1 (b) of article 1 of this Convention.

“2. Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will not apply this Convention to the matters specified in its declaration.

“3. Any declaration made pursuant to paragraphs 1 and 2 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.]”

#### *Paragraph 1*

28. It was recalled that, at its forty-first session, the Working Group had agreed to consider, at a later stage, a provision allowing a contracting State to exclude the application of paragraph 1 (b) of article 1 along the lines of article 95 of the United Nations Convention on Contracts for the International Sale of Goods (the “United Nations Sales Convention”)<sup>2</sup> (A/CN.9/528, para. 42). The Working Group noted that it had not yet concluded its deliberations on possible exclusions to the preliminary

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<sup>2</sup> United Nations, *Treaty Series*, vol. 1489, No. 25567.

draft convention under draft article 2 (A/CN.9/527, paras. 83-98). It was further noted that, as drafted, paragraph 1 was premised on the assumption that variant A of paragraph 1 of draft article 1 would ultimately be adopted.

29. It was pointed out that the United Nations Sales Convention included a provision extending its scope of application when the rules of private international law led to the application of the law of a contracting State (para. 1 (b) of article 1), and also allowed a State to declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it would not be bound by that subparagraph (article 95) and that the draft convention should contain a corresponding provision.

30. On that basis, the Working Group agreed to retain paragraph 1 and to delete the square brackets therefrom.

#### *Paragraph 2*

31. In response to a question, it was noted that paragraph 2 was distinct from paragraph 1 in that paragraph 1 intended to exclude the application of the convention altogether where the rules of private international law would otherwise lead to its application, whereas paragraph 2 was concerned with the exclusion of specific matters such as, for example, the exclusion of matters relating to powers of attorney or concerning family law matters.

32. It was stated that, given the existence of draft article 2, the circumstances in which a State should be afforded an opportunity to exclude other matters from the draft convention should be restricted. In response, it was noted that draft article X had been added as a possible alternative, in the event that consensus could not be reached on possible exclusions under draft article 2 to the preliminary draft convention. Additionally, it was stated that, while draft article 2 was concerned with the exclusion of certain types of contractual arrangement, other such matters could arise that a State would also wish to exclude from the coverage of the convention. It was stated that paragraph 2 of draft article X provided a State with flexibility to exclude such matters and that therefore, independently of draft article 2, paragraph 2 was a provision critical to the capability of States to ratify and utilize the convention.

33. Support was expressed for paragraph 2 of draft article X as currently drafted. However, it was suggested that the paragraph should be reformulated to take account of the fact that the types of matter that might need to be excluded by any given State might change depending on the evolution of technology in legal communications. For that reason, a declaration in that respect might need to be made after the deposit of an instrument of ratification, acceptance, approval or accession. To accommodate that fact, it was suggested that the words “at any time” should be inserted into the clause.

34. The Working Group agreed to retain the text in paragraph 2 and include the term “at any time” instead of “at the time of the deposit of its instrument of ratification, acceptance, approval or accession”. It was recognized, however, that paragraph 2 of draft article X could not be assessed in isolation and that it might be necessary to review it in the light of the final decision taken in respect of draft article 2.

*Paragraph 3*

35. A question was raised as to whether the time when a declaration should take effect should coincide with the date that the convention entered into force for the State that made the declaration. It was noted that, while there were precedents in some international instruments where the time when a declaration took effect coincided with the time when the instrument entered into force for the declaring States, there were other precedents where those times did not so coincide.

36. The Working Group noted that article 97, paragraph 3, of the United Nations Sales Convention provided, in part, that a “declaration takes effect simultaneously with the entry into force of this Convention in respect of the State concerned. However, a declaration of which the depositary receives formal notification after such entry into force takes effect on the first day of the month following the expiration of six months after the date of its receipt by the depositary”. A similar provision was contained in paragraph 3 of article 26 of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit.<sup>3</sup> It was agreed that a provision along those lines should be included in the draft paragraph.

37. Subject to those amendments, the Working Group agreed to retain the text of paragraph 3.

**Article Y. Communications exchanged under other international conventions**

38. The text of draft article Y was as follows:

## “Variant A

“1. Except as otherwise stated in a declaration made in accordance with paragraph 2 of this article, a State Party to this Convention [may declare at any time that it] undertakes to apply the provisions of [article 7 and] chapter III of this Convention to the exchange [by means of data messages] of any communications, declarations, demands, notices or requests [, including an offer and acceptance of an offer,] that the parties are required to make or choose to make in connection with or under any of the following international agreements or conventions to which the State is or may become a Contracting State:

“Convention on the Limitation Period in the International Sale of Goods (New York, 14 June 1974)<sup>4</sup> and Protocol thereto (Vienna, 11 April 1980)<sup>5</sup>

“United Nations Convention on Contracts for the International Sale of Goods (Vienna, 11 April 1980)<sup>2</sup>

“United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (Vienna, 17 April 1991)<sup>6</sup>

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<sup>3</sup> General Assembly resolution 50/48, annex.

<sup>4</sup> United Nations, *Treaty Series*, vol. 1511, No. 26119.

<sup>5</sup> *Ibid.*, No. 26121.

<sup>6</sup> *Official Records of the United Nations Conference on the Liability of Operators of Transport Terminals in International Trade, Vienna, 2-19 April 1991* (United Nations publication, Sales No. E.93.XI.3), part I, document A/CONF.152/13, annex.



“United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 11 December 1995)<sup>3</sup>

“United Nations Convention on the Assignment of Receivables in International Trade (New York, 12 December 2001).<sup>7</sup>

“[2. Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will also apply this Convention to the exchange by means of data messages of any communications, declarations, demands, notices or requests under any other international agreement or convention on private commercial law matters to which the State is a contracting State and which are identified in that State’s declaration.]

“3. Any State may declare at any time that it will not apply this Convention [or any specific provision thereof] to international contracts falling within the scope of [any of the above conventions.] [one or more international agreements, treaties or conventions to which the State is a Contracting Party and which are identified in that State’s declaration.]

“4. Any declaration made pursuant to paragraphs 1 and 2 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.

“Variant B

“1. Any State may at any time make a reservation to the effect that it shall apply this Convention [or any specific provision thereof] only to data messages in connection with an existing or contemplated contract to which, pursuant to the law of that State, a specific international convention clearly identified in the reservation made by that State is to be applied.

“2. Any declaration made pursuant to paragraph 1 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.

“Variant C

“1. Any State may declare at any time that it will not apply this Convention [or any specific provision thereof] to data messages in connection with an existing or contemplated contract to which one or more of the international conventions referred to in article 1, paragraph 1, are to be applied, provided that the relevant conventions shall be clearly identified in the declaration made by that State.

“2. Any declaration made pursuant to paragraph 1 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.”

#### *General remarks*

39. The Working Group noted that the draft article was intended to offer a possible common solution for some of the legal obstacles to electronic commerce under existing international instruments that had been identified in a survey contained in

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<sup>7</sup> General Assembly resolution 56/81, annex.

an earlier note by the Secretariat (A/CN.9/WG.IV/WP.94). At the fortieth session of the Working Group, it had been generally agreed to proceed in that manner, to the extent that the issues were common, which was the case at least with regard to most issues raised under the instruments listed in variant A (A/CN.9/527, paras. 33-48).

40. The Working Group noted that variant A was intended to remove doubts as to the relationship between the rules contained in the draft convention and rules contained in other international conventions. It was not the purpose of the variant to effectively amend or otherwise affect the application of any other international convention. In practice, the draft article would have the effect of an undertaking by a contracting State to use the provisions of the draft convention to remove possible legal obstacles to electronic commerce that might arise under those conventions and to facilitate their application in cases where the parties conducted their transactions through electronic means.

41. The Working Group noted that variant B had been included following a proposal submitted at the forty-second session of the Working Group (A/CN.9/WG.IV/XLII/CRP.2). That variant was logically related to variant A of draft article 1. Its practical effect would be to limit the applicability of the draft convention only to messages exchanged under conventions specifically identified by contracting States. Variant C, which had also been originally submitted with variant B, had been included in the event that the Working Group decided to choose variant B of draft article 1, so as to give the contracting States the option of excluding the application of the draft convention in respect of certain specific conventions. It was noted that if either variant B or variant C were to be adopted, the title of the draft article would need to be changed to “reservations”.

#### *Relationship between draft articles Y and 1*

42. The Working Group held an extensive discussion on the relationship between draft article Y and the definition of the scope of application of the draft convention under draft article 1.

43. The view was expressed that the relationship between the two draft articles was unclear and that draft article Y was not necessary. It was stated that, in many legal systems, the draft convention could be applied to the use of data messages in the context of a contract covered by an international convention, including any of those conventions listed in draft article Y, simply by virtue of draft article 1, without the need for a specific reference to a convention governing such a contract in draft article Y. However, by providing a list of conventions, draft article Y appeared to suggest that the draft convention would not apply to data messages exchanged in connection with contracts covered by any convention other than those listed therein. It would be preferable simply to provide the contracting States with the possibility of expressly excluding the matters they did not want to have covered by the draft convention.

44. In response, it was observed that, as currently drafted, draft articles 1 and Y distinguished between three groups of international contracts. The first group, which probably included the vast majority of international contracts other than sales contracts covered by the United Nations Sales Convention, comprised international contracts that were not covered by any existing uniform law convention. The second group comprised contracts falling under existing international conventions other than those listed in draft article Y or expressly mentioned by a contracting State in a declaration made under draft paragraph 2. The last group comprised contracts

governed by any of the conventions listed in paragraph 1 or mentioned in a declaration made under paragraph 2 of draft article Y. The first group of contracts, it was stated, fell under the scope of application of the draft convention if they met the conditions of draft article 1. The third group of contracts would also benefit from the provisions of the draft convention in accordance with draft article Y, paragraphs 1 and 2. However, data messages exchanged in connection with contracts belonging to the second group would not be covered by the draft convention.

45. That result, it was further observed, followed from earlier deliberations of the Working Group, in particular from the recognition, in connection with a survey of possible legal obstacles in selected international instruments that had been conducted by the Secretariat (A/CN.9/WG.IV/WP.94), that the possible problems raised by certain existing conventions might require specific treatment and that it might not be appropriate to attempt to address those problems in the context of the draft convention (A/CN.9/527, para. 29; see also paras. 24-71). Typical examples included international conventions dealing with negotiable instruments or transport documents.

46. While the Working Group acknowledged that other interpretations were possible as to the interplay between draft articles 1 and Y, it was generally accepted that, as currently drafted, draft articles 1 and Y appeared to be based on a distinction between those three types of contract. The Working Group agreed that it was important to avoid the appearance of a conflict between draft articles 1 and Y and that the Working Group should consider ways of clarifying the relationship between the two provisions when it considered draft article 1.

#### *Choice between the three variants*

47. The view was expressed that variant B had the advantage over variant A of giving the contracting States the freedom, at an appropriate time, to choose those situations covered by international instruments to which the provisions of the draft convention should apply. Variant A, in turn, contemplated the automatic application of the provisions of the draft convention to data messages exchanged in connection with contracts covered by the conventions listed therein, with the possibility of further additions or exclusions by way of declarations made under draft paragraphs 2 or 3, as appropriate. It was stated that variant A placed upon the contracting States the burden of reviewing their treaty obligations in the light of the draft convention to ensure that the provisions of the draft convention would not create difficulties in the operation of any existing instrument.

48. While there was some support for variant B, the widely prevailing view was that variant A was preferable and should be retained as the basis for the future deliberations of the Working Group. It was pointed out that variant A ensured a higher degree of legal certainty by specifically listing a number of conventions, the operation of which would benefit from the provisions of the draft convention. It was also widely felt that variant B was not conducive to the degree of harmonization envisaged by the Commission, as it would leave it to each contracting State to choose unilaterally the transactions covered by an international instrument to which the provisions of the draft convention should apply.

*Variant A, paragraph 1*

49. The Working Group was reminded that one of the principles that underlay its work towards the removal of possible legal obstacles to electronic commerce in existing international instruments was that efforts should be made to formulate solutions that obviated the need for amending individual international conventions. Draft paragraph 1 of article Y was intended to facilitate electronic transactions in the areas covered by the conventions listed therein, but was not meant to formally amend any of those conventions. For that purpose, the draft paragraph contemplated that, by ratifying the draft convention, a State would automatically undertake to apply the provisions of the draft convention to data messages exchanged in connection with any of the conventions listed in paragraph 1. That solution, it was stated, aimed at providing a domestic solution for a problem originating in international instruments, based on the recognition that domestic courts already had the power to interpret international commercial law instruments. The draft paragraph ensured that a contracting State would incorporate in its legal system a provision that directed its judicial bodies to use the provisions of the draft convention to address legal issues relating to the use of data messages in the context of those other international conventions.

50. Support was expressed for the approach envisaged in the draft paragraph. It was stated that extensive consultations with treaty authorities in some countries had indicated that there were no legal objections under traditional treaty law and practice or under the Vienna Convention on the Law of Treaties<sup>8</sup> to the approach proposed in the draft paragraph. While the matter might still require further study and consultation, the proposed solution was welcome in view of the widely shared goal of avoiding amendments to other conventions or issuing authoritative interpretations of their terms.

51. Questions were nevertheless raised concerning the feasibility and implications of the approach proposed in the draft paragraph. It was stated that, if the draft convention was meant to clarify the meaning of terms that were used in other international conventions, that objective should be clearly stated in paragraph 1 of draft article Y. In response, it was firstly noted that the intended effect of the draft convention in respect of contracts covered by other international conventions was not merely to interpret terms used elsewhere, but to offer substantive rules that allowed those other conventions to operate effectively in an electronic environment. Secondly, and more importantly, it was stated that expressly declaring that the draft convention intended to interpret terms used in existing international conventions might be objectionable under public international law, as an authoritative interpretation of an existing treaty could only be issued by the contracting parties to the treaty.

52. It was pointed out that draft article Y referred to “communications, declarations, demands, notices or requests” that might be exchanged by the parties, whereas draft article 1 referred to “the use of data messages in connection with an existing or contemplated contract”. The Working Group took note of that point and agreed that it should revert to it when considering draft article 1.

53. The Working Group noted that the language in the first set of square brackets was intended to give contracting States the flexibility to decide, by a declaration that might be made at any time, whether to apply the provisions of the draft convention to data messages exchanged in connection with contracts covered by any or all of the conventions listed in paragraph 1. There was support for that approach,

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<sup>8</sup> United Nations, *Treaty Series*, vol. 1155, No. 18232.

which was stated to have the advantage of avoiding the impression that the draft article aimed at amending existing conventions. Indeed, the words “may declare at any time” emphasized that the decision to apply the draft convention in those situations was not the result of a treaty obligation, but the consequence of a unilateral decision of the respective contracting State. The Working Group was initially inclined to retain the words “may declare at any time that it” by deleting the square brackets around them. However, it was pointed out that, by doing so, the Working Group would render the extension of the provisions of the draft convention to other instruments, which currently operated automatically upon ratification, subject to a later declaration by the contracting State. It was noted that such a result would be undesirable, since it would reduce the legal harmonization effect of the draft provision and would counter the inner logic of the draft article, as evidenced by the opening sentence in draft paragraph 1 and the link between that paragraph and draft paragraph 3. In view of those considerations, the Working Group eventually agreed that the words “may declare at any time that it” should be deleted.

54. It was noted that the specific reference to the substantive provisions of the draft convention contained in chapter III was intended to avoid the impression that the provisions on the scope of application of the draft convention would affect the definition of the scope of application of other international conventions. Against that background, the Working Group proceeded to consider whether the draft paragraph should also refer to other provisions of the draft convention. It was proposed that the reference to draft article 7 and chapter III should be replaced with a reference to articles 2 to 6 and chapter III. It was stated, in that connection, that the provisions of draft article 7, like those of article 1, were not suitable to be applied in the context of other international conventions, since they might interfere with the existing interpretation of those conventions. Draft articles 2 to 6, in turn, contained substantive provisions that supported the operation of chapter III. Another proposal was not to refer to draft article 7 but to draft articles 7 bis, article 3, except for subparagraph (a), and articles 4 and 5. In particular, there were objections to including a reference to draft article 2, as it was considered that the exclusions from the scope of application of the draft convention should not be incorporated in draft article Y, paragraph 1, since each convention had its rules on excluded matters and there should be no overlap between possibly differing sets of exclusions.

55. Having considered the various views concerning which cross references should and which should not be included in the draft paragraph, the Working Group became increasingly aware of the difficulty of drawing up a comprehensive list of provisions. It was suggested, in that connection, that a list might not be necessary and might even present some disadvantages. It would be preferable, it was stated, to leave it for a body applying the draft convention to establish which provisions might be relevant in respect of the exchange of data messages in connection with any of the conventions listed in the draft paragraph. If any provision in the draft convention was not appropriate for certain transactions, that circumstance should be clear to a reasonable person applying the draft convention.

56. It was suggested that it was not appropriate to list international agreements or conventions that had not yet entered into force under paragraph 1 of draft article Y. Two of the conventions listed under variant A of draft article Y had not yet entered into force, namely, the United Nations Convention on the Liability of Operators of Transport Terminals in International Trade<sup>6</sup> and the United Nations Convention on the Assignment of Receivables in International Trade.<sup>7</sup>

57. The question was raised as to whether it was appropriate under public international law or treaty practice to refer to instruments that had not yet entered into force. In response, it was pointed out that there were several precedents for references in a convention to international instruments that had not yet entered into force at the time the convention had been drafted. One example that resulted from the work of UNCITRAL was the preparation, at the time of the finalization of the United Nations Sales Convention, in 1980, of a protocol to adapt the Convention on the Limitation Period in the International Sale of Goods<sup>4</sup> of 1974, at that time not yet in force, to the regime of the United Nations Sales Convention.

58. Furthermore, it was important to develop forward-looking rules that stood the passage of time. The rule in the draft paragraph should be flexible enough to accommodate a future entry into force of one or other convention without requiring it to be amended at a later stage. Nevertheless, it was agreed that the consideration of the matter by the Working Group might be aided by the provision, in due course, of further information on treaty practice in that regard.

59. Turning to the formulation of the draft paragraph, the Working Group agreed to retain the words “by means of data messages”, as well as the words “including an offer and acceptance of an offer” and to remove the square brackets around them. Subject to those amendments and its earlier deliberations, the Working Group generally approved the draft paragraph.

*Variant A, paragraph 2*

60. The view was expressed that the reference to “any other international agreement or convention on private commercial law matters” unnecessarily restricted the application of paragraph 2. It was suggested that the draft convention could have value for many States in connection with matters other than those relating strictly to private commercial law. On that basis, it was suggested that the words “on private commercial law matters” should be deleted. Some support was expressed for that proposal.

61. A concern was expressed that the removal of the words “on private commercial law matters” could result in a State applying the draft convention to situations covered by other international instruments for which the provisions of the draft convention were not appropriate, which might run counter to that State’s obligations under those other instruments. However, it was noted that the possibility that a State might take legislative action that was inconsistent with its international obligations existed independently of paragraph 2. In response, it was emphasized that paragraph 2 did not impose obligations upon States, but merely provided States with an opportunity to make a declaration that the draft convention applied to other international instruments. It was stated that paragraph 2 had been premised on the assumption that a State would only make use of that option after it had undertaken a thorough analysis to determine if its application was appropriate to the international instrument in question.

62. Nonetheless, in order to allow a broader range of instruments access to the regime of the draft convention, it was suggested that paragraph 2 could refer to instruments bearing a relationship to the mandate of UNCITRAL. The Working Group agreed with that suggestion and asked the Secretariat to revise paragraph 2 with language that tied the types of instrument to those that related to the mandate of UNCITRAL.

63. A suggestion was made to include the words “at any time” instead of the words “at the time of the deposit of its instrument of ratification, acceptance, approval or accession”. It was stated that that proposal was consistent with a decision already taken in respect of draft article X, paragraph 2 (see para. 33 above). The Working Group agreed with that suggestion and requested the Secretariat to revise paragraph 2 accordingly.

*Variant A, paragraph 3*

64. It was suggested that the phrase “or any specific provision thereof” should be deleted for the reason that a State choosing to adopt the draft convention should not be permitted to apply only some of the provisions of the draft convention. It was stated that such an approach would create uncertainty as to which provisions of the draft convention applied in any given jurisdiction. However, some support was expressed for the retention of those words as it allowed States that could not adopt the convention as a whole to apply at least part of the draft convention. That suggestion did not receive support. The Working Group agreed to delete the words “or any specific provision thereof”.

65. It was suggested that, of the two alternative bracketed texts set out in paragraph 3, the first, “any of the above conventions”, was preferable, but that, given that paragraph 2 set out an option for States that was presumably revocable, whereas paragraph 1 imposed an obligation, the reference should be modified to read “any of the above conventions listed under paragraph 1”.

66. However, some support was expressed for the second alternative, “one or more international agreements, treaties or conventions to which the State is a Contracting Party and which are identified in that State’s declaration”. It was suggested that that text allowed a State greater flexibility in dealing with any concerns it might have about the relationship of the draft convention to other international instruments to which it might be a party. It was stated that the second alternative provided flexibility for States to ensure that a matter that a State did not want covered was, in fact, not covered and that that flexibility would facilitate adoption of the draft convention. In response it was noted that the concern could be met by providing that the convention only applied to contracts covered by the conventions listed in paragraph 1 or not covered by any international instrument. To that end, the words “including any of the conventions listed in paragraph 1” could be added following the words “any of the above conventions”.

67. A question was raised as to the scope of draft article Y in respect of contracts that would become subject to international instruments in the future. For example, a contract relating to the licensing of software, unless it was excluded in draft article 2 of the draft convention, would fall within the scope of the draft convention. If, however, a convention relating to that subject matter was subsequently made, then that contract would fall outside the draft convention on the basis that that later convention was neither listed in paragraph 1 nor the subject of a declaration under paragraph 2. In response it was stated that, in that case, if the State wished the draft convention to apply, it would ensure that a reference was made in the later convention, or would submit a declaration in respect of that convention under paragraph 2 of draft article Y. In any event, that concern was not logically related to the draft paragraph and should be discussed in relation to draft article 1 (see also para. 76 below).

68. Having regard to the differing views as to the appropriate interpretation of the draft article, a proposal was made to combine the two alternative bracketed texts currently contained in paragraph 3, to the effect that any State might declare at any time that it would not apply the draft convention to international contracts that fell within the scope of one of more international agreements, treaties or conventions, including those listed under paragraph 1, to which the State was or might become a party and which were identified in that State's declaration.

69. The view was expressed that the reference to "international contracts" was not consistent with the drafting approach taken in paragraphs 1 and 2, which focused on exchanges by means of data messages of any communications relating to an international agreement. It was agreed that the Secretariat should review the language used in paragraph 3 and align it with other paragraphs of draft article Y.

*Variant A, paragraph 4*

70. It was agreed that paragraph 4 should be reformulated so as to align the text with the amendments to paragraph 3 of draft article X that had been agreed upon (see paras. 35-37 above). On that basis, it was decided that language along the lines of that contained in the first sentence of paragraph 3 of article 97 of the United Nations Sales Convention should be included in paragraph 4. Subject to those amendments, the Working Group agreed to retain the text of paragraph 4.

## **Article 1. Scope of application**

71. The text of draft article 1 was as follows:

"1. This Convention applies to the use of data messages in connection with an existing or contemplated contract between parties whose places of business are in different States:

"Variant A

"(a) When the States are Contracting States;

"(b) When the rules of private international law lead to the application of the law of a Contracting State; or

"(c) When the parties have agreed that it applies.

"Variant B

"... when these States are Parties to this Convention and the data messages are used in connection with an existing or contemplated contract to which, pursuant to the law of these States Parties, one of the following international conventions is to be applied:

"Convention on the Limitation Period in the International Sale of Goods (New York, 14 June 1974)<sup>4</sup> and Protocol thereto (Vienna, 11 April 1980)<sup>5</sup>

"United Nations Convention on Contracts for the International Sale of Goods (Vienna, 11 April 1980)<sup>2</sup>

"United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (Vienna, 17 April 1991)<sup>6</sup>



“United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 11 December 1995)<sup>3</sup>

“United Nations Convention on the Assignment of Receivables in International Trade (New York, 12 December 2001).<sup>7</sup>

“2. The fact that the parties have their places of business in different States is to be disregarded whenever this fact does not appear either from the contract or from any dealings between the parties or from information disclosed by the parties at any time before or at the conclusion of the contract.

“3. Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of this Convention.”

*General remarks: relationship between draft articles 1 and Y*

72. At the beginning of its deliberations on draft article 1, the Working Group decided that, in view of its earlier decision to retain only variant A of draft article Y (see para. 47 above), variant B of draft article 1 had become redundant. The Working Group therefore agreed to use only variant A as a basis for its discussions on draft article 1.

73. The Working Group was, however, reminded of the fact that its earlier discussions on draft article Y had not exhausted the questions pertaining to the relationship between that provision and the provisions on the scope of application of the draft convention, which the Working Group had agreed to return to once it had reached draft article 1 (see para. 45 above).

74. There was general agreement within the Working Group that, once the conditions of paragraph 1 of the draft article were met, the draft convention would automatically apply to data messages exchanged in connection with international contracts that were not governed by any existing international convention. The views differed only with regard to messages relating to contracts governed by existing international conventions.

75. The prevailing view within the Working Group was that, in those cases, the combined effect of variant A of draft article 1 with draft article Y, paragraphs 1, 2 and 3, would be that, by ratifying the draft convention, a contracting State would make it clear that the provisions of the draft convention applied to messages exchanged in connection with contracts falling under any of the international conventions referred to in draft article Y, paragraph 1, or mentioned in a declaration made in accordance with draft article Y, paragraph 2, and which were not subject to a particular exclusion under draft article Y, paragraph 3. Any other reading of draft articles 1 and Y, it was stated, might place the contracting States under the unreasonable burden of having to review their entire body of treaty and conventional law so as to ascertain whether the draft convention would be compatible with existing international obligations.

76. That view, however, was not unanimously shared and strong arguments were made to the effect that the provisions of the draft convention might also be given broad application, even in respect of data messages relating to contracts that were covered by an international instrument not listed in draft article Y, paragraph 1, or in a declaration made under draft article Y, paragraph 2. Under that option, the provisions of the draft convention would also apply to those data messages unless and until the relevant contracting State had made a declaration expressly excluding

the application of the provisions of the draft convention under draft article Y, paragraph 3. In support of that view, it was stated that the list of instruments in draft article Y, paragraph 1, or any declaration made under draft article Y, paragraph 2, should be regarded as non-exhaustive clarifications intended to remove doubts as to the application of the draft convention, but not as effective limitations to its reach.

77. In that connection, the view was expressed that there was an intermediate situation that was not adequately addressed by the understanding given to draft articles 1 and Y by the prevailing view within the Working Group. It was stated that a problem might arise in respect of exchanges of data messages under contracts that were not currently covered by any international convention but that might in the future become the subject of an international uniform law instrument. Presently, those data messages would fall under the draft convention if they met the requirements of draft article 1, paragraph 1. A narrow reading of draft article Y, as favoured by the majority, would, however, lead to the undesirable result that, once those contracts became the subject of a new international instrument, the data messages relating to them would automatically fall outside of the draft convention. In response, it was pointed out that the draft convention did not contemplate a solution for such a situation, but nothing in the draft convention prevented States that, in the future, negotiated a new convention intended to govern a specific type of contract from making reference to the draft convention or, if they were themselves contracting parties to the draft convention, to subsequently issue declarations of inclusion under draft article Y, paragraph 2.

78. The Working Group proceeded to consider possible additional provisions aimed at clarifying the relationship between draft articles 1 and Y. It was agreed that the Working Group could consider inserting an additional paragraph in draft article 1, or immediately thereafter, according to which the draft convention would not apply to the exchange of data messages that fell under draft article 1, whenever the contract to which those data messages related was governed by an international convention, treaty or agreement which was not referred to in draft article Y, paragraph 1 and was not the subject of a declaration made by a contracting State under draft article Y, paragraph 2.

79. That new provision, it was further proposed, should include, as an alternative option within square brackets, another provision to the effect that the draft convention would apply to the exchange of data messages that fell under draft article 1 even if the existing or contemplated contract to which those data messages related was governed by an international convention, treaty or agreement that had not been expressly referred to in draft article Y, paragraph 1, or had not been the subject of a declaration made by a contracting State under draft article Y, paragraph 2, as long as such application had not been excluded pursuant to a declaration made under draft article Y, paragraph 3. It was further suggested that the second option might be combined with a provision that allowed a contracting State to generally exclude the possibility of an extended application of the provisions of the draft convention to matters covered in international conventions other than those listed in draft article Y, paragraph 1. It was noted, however, that either option might require consequential adjustments in draft article Y and that not all provisions of draft article Y might be compatible with one or other option. Furthermore, any provisions that contemplated a broad application of the convention in connection with matters covered by other international conventions might need to be circumscribed to international commercial law instruments or trade-related conventions relevant to the mandate of UNCITRAL.

80. While the Working Group took note of the reiterated objections to admitting a broad application of the draft convention, it was recognized that the Working Group could not close the matter at the current stage and that both possibilities should be contemplated in a revised version of the draft convention for future consideration by the Working Group.

81. The view was expressed that, regardless of the final decision that might be taken in connection with those two options, the relationship between draft articles 1 and Y might be further clarified if paragraph 1 of draft article Y were to be incorporated into draft article 1 or at least placed closer to draft article 1. In response, it was observed that paragraph 1 of draft article Y could not be dissociated from paragraphs 2 and 3 of that article. However, to the extent that those provisions dealt with declarations by the contracting States, they were better placed among the final provisions of the draft convention, in accordance with established treaty practice. Furthermore, it was noted that draft article 1 provided an autonomous scope of application for the draft convention. By virtue of draft article Y, the provisions of the draft convention might also apply to data messages relating to contracts governed by other conventions. However, the draft convention did not apply as such to those other conventions.

*Additional provision on purpose*

82. The Working Group generally agreed that it would be useful to include a provision in the draft convention, either as a preambular clause or as an operative article, that stated the general purpose of the draft convention. One such proposal was to state that the draft convention had the purpose of affirming the liberty of choice and the interchangeability of media and technologies in the context of international commerce, in particular in the context of international contracts, to the extent that the means used complied with the purpose of the relevant rules of law. Other possible elements, it was suggested, might be considered by the Working Group at a later stage.

*Definition of substantive scope of application in paragraph 1*

83. The view was expressed that the phrase “in connection with an existing or contemplated contract” was too broad and that it might suggest that the provisions of the draft convention would apply to the exchange of communications or notices between the parties to a contract and third parties, whenever those communications had a “connection” to the contract. It was stated that certain contracts might require, for example, notification to a public authority, and that the current wording of the draft paragraph seemed to authorize that such notifications be given electronically. Therefore, it was suggested that the current text of the draft paragraph should be reworded to make it clear that the draft convention applied only to exchanges between the parties to an existing or contemplated contract. The Working Group concurred with that suggestion and agreed that appropriate language should be included in a future version of the draft paragraph.

84. The view was expressed that it was inaccurate for the draft paragraph to refer to “parties” of a contemplated contract, since the notion of parties to a contract presupposed that a contract already existed. It might be better to refer instead to “parties to the negotiation of a contemplated contract”. In response, it was pointed out that the draft convention was also meant to apply to communications made at a time when no contract—and possibly not even a negotiation of a contract—had yet come into being. Draft article 11, dealing with invitations to make offers, was an

example of such a case. The Working Group acknowledged, however, that the wording of the draft paragraph might be improved.

85. The view was expressed that the expression “existing or contemplated contract” might be understood as referring to a contract in existence at the time the draft convention entered into force. The Working Group agreed to request the Secretariat to offer alternative language in order to avoid that impression. The Working Group further agreed that the draft convention might need to include a specific provision containing transitional rules to deal with the time when the provisions of the convention would take effect and how they would affect contracts concluded or in negotiation at such time.

86. Having considered those observations, the Working Group noted that the wording of paragraph 1 might generally require further adjustment, in particular with a view to harmonizing it with the wording of draft article Y. The Secretariat was requested to bear that in mind when formulating a revised version of the draft paragraph.

*Paragraph 1 (a)*

87. The view was expressed that subparagraph (a) of paragraph 1 was not necessary and should be deleted. That provision, it was stated, created a double requirement for the application of the draft convention, which would be automatically excluded whenever one of the States involved was not a contracting State of the draft convention. It was further stated that, to the extent that several provisions of the draft convention were intended to support or facilitate the operation of other laws in an electronic environment (such as, for example, draft articles 8 and 9), the requirements resulting from subparagraph (a) would lead to the unacceptable result that a domestic court might be mandated to interpret the provisions of its own laws (for instance, in respect of form requirements) in different ways, depending on whether or not the parties to a contract were located in contracting States of the draft convention. The application of the draft convention would be simplified and its practical reach greatly enhanced if it were simply to apply to international contracts, that is, contracts between parties in two different States, without the cumulative requirement that both those States should also be contracting States of the draft convention. Strong support was expressed for that proposal, although the views differed as to whether both subparagraphs (b) and (c) might be deleted as well, or only one or the other of those provisions.

88. The countervailing view, which also obtained strong support, emphasized that the current wording was based on paragraph 1 (a) of article 1 of the United Nations Sales Convention and should be retained. The existing formulation had the advantage of allowing the parties to determine easily whether or not the draft convention would apply to their contract, without having first to ascertain which would be the applicable law of the contract. The possibly narrower geographic field of application offered by that option was compensated for by the advantage of the enhanced legal certainty provided by it.

89. At that juncture, the Working Group was reminded that the first version of the draft convention had contained a variant whereby the instrument would apply to communications exchanged between parties located in two different States, without requiring that both States should have ratified the draft convention (A/CN.9/WG.IV/WP.95, annex I). The Working Group, in its first reading of the draft convention, had not favoured that option because it was not parallel to

article 1, paragraph 1 (a) of the United Nations Sales Convention (A/CN.9/509, para. 37). The need for such a parallelism between the two instruments, however, was stated to be no longer valid. That conclusion, it was explained, flowed logically from the Working Group's understanding, reached during its consideration of draft article Y (see para. 53, above), that the respective scopes of application of the draft convention and other international instruments were independent of one another.

90. The Working Group held an extensive discussion on the proposed amendment to the definition of the geographic scope of application of the draft convention. The Working Group eventually agreed to retain paragraph 1 (a) of draft article 1. However, the Working Group also agreed that, for future consideration, a revised version of the draft convention should contain, in an appropriate place, a provision authorizing a State to make a declaration that it would apply the provisions of the convention to exchanges of data messages in connection with international contracts whenever parties had their places of business in different States, even if only one of the States in question was a party to the draft Convention.

*Paragraph 1 (b)*

91. The suggestion was made that subparagraph (b) of paragraph 1 should be deleted, since the rule contained therein was not conducive to legal certainty. Subparagraph (b), it was stated, could lead to the application of the convention by virtue of the operation of rules of private international law, even though the forum State had not adopted the draft convention. It was suggested that if the parties elected to subject their exchanges of communications to the provisions of the draft convention, they had the possibility of doing so under subparagraph (c). The parties should not, however, be brought under the regime of the draft convention only because a third State applied the convention when they had not anticipated that result.

92. In response, it was suggested that subparagraph (b) reproduced a rule that was contained in the provisions on the sphere of application of other UNCITRAL instruments. The rule was stated to be useful to allow for an expanded geographic scope of application for the draft convention, since it did not require that the States where the parties to the contract were located had both to be contracting States of the convention. While there had been objections to that rule at an earlier session (A/CN.9/509, para. 38), the Working Group had thus far agreed to retain the subparagraph (A/CN.9/528, para. 42). For those States that might have difficulty applying subparagraph (b), it was possible to exclude its application by virtue of a declaration under draft article X, paragraph 1. The making of such a declaration would result in the convention being not applicable if the rules of private international law of a contracting State would lead to the application of the law of the State having made such an exclusionary declaration.

93. After the Working Group had noted the various views expressed and the fact that there was insufficient support for deleting the subparagraph, it was decided that the provision should be retained for future consideration.

*Paragraph 1 (c)*

94. It was pointed out that the possibility provided for in subparagraph (c) of paragraph 1 was also contemplated, for instance, in article 1, paragraph 2, of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit.<sup>3</sup>

95. The question was asked as to whether subparagraph (c) contemplated an agreement to subject a contract to the laws of a given State or to incorporate the terms of the draft convention as such into the relevant contract. While the first situation was stated to be widely accepted in most legal systems, the second possibility might not always be possible. An international convention on private law matters only had legal effect for private parties to the extent that the convention in question had been given effect domestically. Thus, choice-of-law clauses referring to an international convention were usually enforced as incorporation of foreign law, but not as enforcement of the international convention as such. Furthermore, the situation contemplated in the subparagraph would be particularly objectionable if it were to allow the parties to effectively violate mandatory rules of the governing law. The precedents of similar rules in other international conventions, it was further stated, were not entirely relevant, since, for instance, the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit<sup>3</sup> dealt with one particular type of contract, while the draft convention dealt with general issues that touched upon various areas of law.

96. In response, it was pointed out that disputes involving international contracts were not solved exclusively by State courts and that arbitration was a widespread practice in international trade. Arbitral tribunals, it was further stated, were often not specifically linked to any particular geographic location and often ruled on the disputes submitted to them on the basis of the law chosen by the parties. In practice, choice-of-law clauses did not always refer to the laws of particular States. Instead, there were often cases where the parties had chosen to subject their contracts to an international convention independently from the laws of any given jurisdiction. That the choice of an international convention to govern a contract was not dependent upon domestic law was evidenced by article 2, paragraph 1 (e) of the United Nations Convention on the Carriage of Goods by Sea,<sup>9</sup> which applied to a contract of carriage, *inter alia*, when a bill of lading stated that the provisions of the Convention or the legislation of any State giving effect to them were to govern the contract of carriage.

97. After the Working Group had noted the various views expressed and the fact that there was insufficient support for deleting subparagraph (c), it was decided that the provision should be retained for future consideration.

## Article 2. Exclusions

98. The text of draft article 2 was as follows:

“This Convention does not apply to the use of data messages [in connection with the following contracts, whether existing or contemplated] [in the context of the formation or performance of the following contracts]:

“(a) Contracts concluded for personal, family or household purposes [unless the party offering the goods or services, at any time before or at the conclusion of the contract, neither knew nor ought to have known that they were intended for any such use];

“[(b) Contracts for the grant of limited use of intellectual property rights;]

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<sup>9</sup> *Ibid.*, vol. 1695, No. 29215.

“(c) [Other exclusions that the Working Group may decide to add.] [Other matters identified by a Contracting State under a declaration made in accordance with article X].”

#### *Chapeau*

99. It was noted that the chapeau of draft article 2 contained alternative bracketed texts that the Working Group would have to consider at a later stage.

#### *Subparagraph (a)*

100. It was pointed out that the draft subparagraph excluded consumer contracts by using the same technique as that used in article 2, subparagraph (a), of the United Nations Sales Convention. However, the final part of that clause, namely, “unless the party offering the goods or services, at any time before or at the conclusion of the contract, neither knew nor ought to have known that they were intended for any such use”, was in square brackets in line with a suggestion to delete those words that had received some support at the forty-first session of the Working Group (A/CN.9/528, para. 52).

101. There was general agreement that it was very important to exclude consumer transactions from the draft convention as it contained a number of rules that were inappropriate in the context of consumer transactions. It was suggested that a rule such as that contained in draft article 10, paragraph 2, for example, which contained a rule that presumed receipt of a data message from the moment that it was capable of being retrieved by the addressee was inappropriate in the context of transactions involving consumers, as consumers could not be expected to check their e-mails regularly nor to be able to distinguish easily between legitimate commercial messages and spam mail. It was suggested that consumers should not be held to the same standards as persons engaged in commercial activities.

102. It was further pointed out that, in consumer transactions, the treatment of errors and the consequences of errors would typically require specific legal rules at a much higher level of detail than the general provisions contained in draft article 14. Another example of possible tension was that consumer protection rules typically contemplated an obligation for the vendor to make available to the consumer the contract terms in a manner accessible to the consumer. Furthermore, consumer protection rules relating to electronic transactions also specified the conditions under which standard contractual terms and conditions could be invoked against a consumer and when a consumer could be presumed to have expressed his or her consent to terms and conditions incorporated by reference into the contract. None of those issues was dealt with in the draft convention in a manner that would offer the degree of protection that consumers enjoyed in several legal systems. The Working Group agreed that consumers should be excluded from the reach of the draft convention.

103. It was suggested that the text contained in square brackets should be retained in order to retain consistency with, and offer the same level of legal certainty as provided by, the United Nations Sales Convention. It was pointed out that the corresponding provision in the United Nations Sales Convention had been considered important to ensure legal certainty and guard against placing the applicability of that Convention entirely on the seller’s ability to ascertain the purpose for which the buyer had bought the goods.

104. The countervailing view, however, was that the bracketed text should be deleted, notwithstanding that it was drawn from the language used in the United Nations Sales Convention. It was suggested that it would be preferable if the exclusion of consumer contracts was not conditional upon the actual or presumed knowledge of the party offering the goods or services. It was observed that the corresponding clause in the United Nations Sales Convention was based on the premise that there could be situations where a sales contract might fall under the Convention despite the fact of it being entered into by a consumer (for an earlier discussion on this point, see A/CN.9/527, paras 83-89). It followed from those provisions that the drafters of the United Nations Sales Convention assumed that there might be situations where a sales contract would fall under the Convention, despite the fact of it having been entered into by a consumer. The legal certainty gained with the provision appeared to have outweighed the risk of covering transactions intended to have been excluded. It was noted, moreover, that, as indicated in the commentary on the draft of the United Nations Convention on Contracts for the International Sale of Goods, which had been prepared at the time by the Secretariat (A/CONF.97/5), article 2, subparagraph (a), of the United Nations Sales Convention was based on the assumption that consumer transactions were international transactions only in “relatively few cases”.

105. It was further stated that, if a new instrument on electronic contracting should exclude consumer transactions, the formulation of article 2, subparagraph (a), of the United Nations Sales Convention might be problematic, as the ease of access afforded by open communication systems not available at the time of the preparation of the Convention, such as the Internet, greatly increased the likelihood of consumers purchasing goods from sellers established abroad. An unconditional exclusion would instead provide sufficient comfort that consumer transactions would under no circumstances fall under the scope of application of the draft convention. Some support was expressed for the proposal to delete the bracketed text.

106. Following extensive discussion, it was agreed to revert to the matter once the Working Group had considered draft article 3, subparagraph (a) (see below, paras. 112-115).

*Subparagraph (b)*

107. It was recalled that the exclusion in subparagraph (b) that related to contracts for the grant of limited use of intellectual property rights was in square brackets as the Working Group had not yet reached an agreement on the matter (A/CN.9/527, paras. 90-93, and A/CN.9/528, paras. 55-60). The Working Group noted that the International Bureau of the World Intellectual Property Organization saw no need for an exclusion clause with regard to contracts involving intellectual property rights (A/CN.9/WG.IV/WP.106, para. 2). On that basis, the Working Group agreed to the deletion of the subparagraph.

*Subparagraph (c)*

Other exclusions

108. It was pointed out that draft subparagraph (c) provided two options in square brackets, the first being to provide a common list of exclusions and the second being to refer to declarations made under draft article X by each of the contracting States. A preference was generally expressed for the first option.



109. A number of matters were suggested for inclusion in the common list of exclusions. It was suggested that certain existing financial service markets should be included in a common list of exclusions under subparagraph (c). It was pointed out that, as stated at previous sessions of the Working Group (A/CN.9/527, para. 95, and A/CN.9/528, para. 61), the financial service sector was subject to well-defined regulatory and non-regulatory rules that addressed issues relating to electronic commerce in an effective way for the worldwide functioning of that sector and that no benefit would be derived from their inclusion in the draft convention. It was also stated that, given the unique nature of that sector, the relegation of such an exclusion to country-based declarations under draft article X would be inadequate to reflect that reality. While support was expressed for the exclusion of that sector, concern was expressed that an exclusion relating to financial service markets might be too broad. In response, it was stated that what was being proposed was not a broad exclusion of financial services per se, but rather specific transactions such as payment systems, negotiable instruments, derivatives, swaps, repurchase agreements (repos), foreign exchange, securities and bond markets, and possibly general procurement activities of banks and loan activities (A/CN.9/527, para. 95, and A/CN.9/528, para. 61).

110. Another suggestion was that subparagraph (c) should exclude the following: contracts that created or transferred rights in real estate, except for rental rights; contracts requiring by law the involvement of courts, public authorities or professions exercising public authority; contracts of suretyship granted by and on collateral securities furnished by persons acting for purposes outside their trade, business or profession; and contracts governed by family law or by the law of succession (A/CN.9/WG.IV/WP.95, annex II). It was noted that the third of those matters, relating to contracts of suretyship, appeared to overlap with the proposal to include a more general exclusion for financial service markets. Yet another proposal was that subparagraph (c) might provide an alternative for excluding from the scope of the draft convention data messages exchanged in connection with contracts governed by certain existing international conventions. That approach might obviate the need for specific exclusions of those conventions by declarations made under draft article X, paragraph 2, or under article Y, paragraph 3. Possible categories for a common list of exclusions included negotiable instruments or documents relating to the carriage of goods.

111. It was decided that those proposals should be reflected in new provisions to be placed in square brackets for discussion at a future session of the Working Group.

### **Article 3. Matters not governed by this Convention**

112. The text of draft article 3 was as follows:

“This Convention does not affect or override any rule of law relating to:

“(a) The protection of consumers;]

“(b) The validity of the contract or of any of its provisions or of any usage [except as otherwise provided in articles [...]];

“(c) The rights and obligations of the parties arising out of the contract or of any of its provisions or of any usage; or

“(d) The effect which the contract may have on the ownership of rights created or transferred by the contract.”

113. It was pointed out that, under subparagraph (a), consumer transactions would not be automatically excluded from the scope of the draft convention but that provisions of the draft convention would not supersede or affect rules on consumer protection. It was noted that, if the bracketed text in subparagraph (a) of draft article 2 were deleted, subparagraph (a) of draft article 3, which in some respects represented an alternative to that subparagraph (A/CN.9/528, para. 52), could also be deleted.

114. However, it was suggested that, if the bracketed text from subparagraph (a) of draft article 2 were retained, it was possible that, in circumstances where the person offering the goods or services neither knew nor ought to have known that the transaction was a consumer transaction, that transaction would be covered by the draft convention. In the light of that possibility, it was stated that it was critical to retain subparagraph (a) of draft article 3 to preserve the operation of laws protecting consumers. In support of that, it was stated that subparagraph (a) should be retained to highlight the fact that the draft convention was not intended to upset consumer protection legislation.

115. Given the apparent connection between the bracketed text in subparagraph (a) of draft article 2 and subparagraph (a) of draft article 3, the Working Group considered the implications of subparagraph (a) of draft article 3.

116. It was noted that the purpose of the bracketed text in subparagraph (a) of draft article 2 was to provide legal certainty for the person providing goods or services who may not be able, in every situation, to ascertain whether or not the other party was or was not a consumer. It was stated that, in that case, subparagraph (a) of draft article 2 clarified that the provisions of the draft convention would apply when the personal or household purpose of a transaction was not apparent to the other party. However, it was stated that the benefit of that legal certainty was undermined by the fact that subparagraph (a) of draft article 3 deferred to consumer protection rules. A contrary view was that subparagraph (a) of draft article 3 was critical to protect consumers, given the implications of including the bracketed text in subparagraph (a) of draft article 2. In view of the evident conflict between the protection of the interests of both types of party, the Working Group concluded that the best way of ensuring legal certainty was to have a clear-cut exclusion in subparagraph (a) of draft article 2 by omitting the bracketed text therein. The Working Group agreed that subparagraph (a) of draft article 3 had thus become redundant and could therefore be deleted.

*Subparagraphs (b), (c) and (d)*

117. The Working Group took the view that, since the provisions of the draft convention did not cover the subject matter in subparagraphs (b), (c) and (d) of draft article 3, those subparagraphs were not necessary. In the light of that observation, the Working Group decided to delete subparagraphs (b), (c) and (d) in their entirety.

118. In the light of its deliberations on subparagraphs (a) to (d), the Working Group decided to delete the draft article.

#### Article 4. Party autonomy

119. The text of draft article 4 was as follows:

“The parties may exclude the application of this Convention or derogate from or vary the effect of any of its provisions [except for the following: ...].”

120. The preference expressed by the Working Group was to have an unconditional application of party autonomy. In that regard, the Working Group agreed that the exceptions thereto within the square-bracketed text should be deleted. In that connection, concern was expressed that the principle of party autonomy should not be understood as authorizing a party to derogate from mandatory form requirements under national laws or to lower the standards for functional equivalence set forth in draft article 9 of the draft convention.

121. In response, it was noted that the draft convention was only intended to provide functional equivalence in order to meet general form requirements and that it did not affect mandatory rules that required, for instance, the use of specific methods of authentication in a particular context. In any event, States remained free to make declarations in that respect under draft article X.

122. With respect to the general form requirements, the provisions in the draft convention were only facilitative in nature. The consequences of parties using a different method would simply be that they would not be able to meet the form requirements contemplated under draft article 9. It was recognized, however, that the matter might need to be considered in the context of draft article 9.

123. A suggestion was made that draft article 4 should also specify the manner in which parties could derogate from the draft convention. In particular, it was suggested that the draft article should clarify that derogation could occur either by explicit exclusion or, for instance, by contractual provision that was contrary to the draft provisions of the draft convention. Although some reservations relating to that proposal were expressed, the Working Group accepted that the proposal could be considered and that additional language to that effect could be included in square brackets.

124. It was noted that a study with respect to contractual practice in respect of derogations from the provisions of the United Nations Sales Convention might assist the Working Group in its deliberations on that matter.

**G. Note by the Secretariat on legal aspects of electronic commerce:  
electronic contracting: provisions for a draft convention,  
working paper submitted to the Working Group on Electronic  
Commerce at its forty-third session  
(A/CN.9/WG.IV/WP.108) [Original: English]**

1. The Working Group began its deliberations on electronic contracting at its thirty-ninth session (New York, 11-15 March 2002), when it considered a note by the Secretariat on selected issues relating to electronic contracting (A/CN.9/WG.IV/WP.95). That note also contained an initial draft tentatively entitled "Preliminary draft convention on [international] contracts concluded or evidenced by data messages" (A/CN.9/WG.IV/WP.95, annex I).
2. At that time, the Working Group held a general exchange of views on the form and scope of the instrument, but agreed to postpone discussion on exclusions from the draft convention until it had had an opportunity to consider the provisions related to the location of the parties and contract formation (see A/CN.9/509, paras. 18-40). The Working Group then took up articles 7 and 14, both of which dealt with issues related to the location of the parties (see A/CN.9/509, paras. 41-65). After it had completed its initial review of those provisions, the Working Group proceeded to consider the provisions dealing with contract formation in articles 8-13 (see A/CN.9/509, paras. 66-121). The Working Group concluded its deliberations on the draft convention at that session with a discussion of draft article 15 on availability of contract terms (see A/CN.9/509, paras. 122-125). The Working Group agreed, at that time, that it should consider articles 2-4, dealing with the sphere of application of the draft convention and articles 5 (Definitions) and 6 (Interpretation), at its fortieth session (see A/CN.9/509, para. 15).
3. The Working Group resumed its deliberations on the preliminary draft convention at its fortieth session (Vienna, 14-18 October 2002). The Working Group began its deliberations by a general discussion on the scope of the preliminary draft convention (see A/CN.9/527, paras. 72-81). The Working Group proceeded to consider articles 2-4, dealing with the sphere of application of the draft convention and articles 5 (Definitions) and 6 (Interpretation) (see A/CN.9/527, paras. 82-126).
4. The Secretariat thereafter prepared a revised version of the preliminary draft convention (A/CN.9/WG.IV/WP.100, annex I). The Working Group, at its forty-first session (New York, 5-9 May 2003), reviewed articles 1-11 of the revised preliminary draft convention (see A/CN.9/528, paras. 26-151). The Secretariat was requested to prepare a further revised version of the preliminary draft convention, for consideration by the Working Group at its forty-second session.
5. At its forty-second session (Vienna, 17-21 November 2003), the Working Group held a general discussion on the scope of the preliminary draft convention (see A/CN.9/546, paras. 33-38). The Working Group noted that a task force had been established by the International Chamber of Commerce to develop contractual rules and guidance on legal issues related to electronic commerce, tentatively called

“E-terms 2004”. The Working Group considered the work being undertaken by that task force as a useful complement to the work being undertaken by the Working Group to develop an international convention. The Working Group proceeded to consider the revised text of the preliminary draft convention (A/CN.9/WG.IV/WP.103, annex I). The Working Group reviewed articles 8-15 and requested a number of changes in connection therewith (see A/CN.9/546, paras. 39-135).

6. The annex to the present note contains the newly revised version of the preliminary draft convention, which reflects the deliberations and decisions of the Working Group at its previous sessions.

## ANNEX<sup>1</sup>

### PRELIMINARY DRAFT CONVENTION<sup>2</sup> ON THE USE OF DATA MESSAGES IN [INTERNATIONAL TRADE] [THE CONTEXT OF INTERNATIONAL CONTRACTS]

#### CHAPTER I. SPHERE OF APPLICATION

##### *Article 1. Scope of application*

1. This Convention applies to the use of data messages in connection with an existing or contemplated contract between parties whose places of business are in different States:

Variant A<sup>3</sup>

(a) When the States are Contracting States;

(b) When the rules of private international law lead to the application of the law of a Contracting State; or<sup>4</sup>

<sup>1</sup> The numbers in square brackets after the article numbers indicate the corresponding numbers in the previous version of the draft convention (A/CN.9/WG.IV/WP.103, annex).

<sup>2</sup> The form of a convention represents a working assumption only (see A/CN.9/484, para. 124) and is without prejudice to a final decision by the Working Group as to the nature of the instrument.

<sup>3</sup> This variant reflects the scope of application of the draft convention essentially as contained in earlier versions. By combining this variant with variant A of draft article Y, a contracting State would make it clear that the provisions of the draft convention apply to messages exchanged under any of the international conventions referred to therein, while preserving the possibility of excluding particular instruments, or adding other instruments as it sees fit.

<sup>4</sup> This paragraph reproduces a rule that is contained in the provisions on the sphere of application of other UNCITRAL instruments. There have been objections to this rule on the grounds that such an expansion of the convention's field of application would significantly reduce certainty at the time of contracting owing to its inherent ex post facto nature (see A/CN.9/509, para. 38). At its forty-first session, the Working Group agreed to retain the subparagraph (see A/CN.9/528, para. 42). If the draft paragraph is retained, the Working Group would still need to consider whether reservations to this rule should be permitted, as was suggested at its forty-second session (see A/CN.9/528, para. 42). See also draft article X, paragraph 1.

(c) When the parties have agreed that it applies.<sup>5</sup>

Variant B<sup>6</sup>

... when these States are parties to this Convention and the data messages are used in connection with an existing or contemplated contract to which, pursuant to the law of these States Parties, one of the following international conventions is to be applied:

Convention on the Limitation Period in the International Sale of Goods (New York, 14 June 1974) and Protocol thereto (Vienna, 11 April 1980)

United Nations Convention on Contracts for the International Sale of Goods (Vienna, 11 April 1980)

United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (Vienna, 17 April 1991)

United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 11 December 1995)

United Nations Convention on the Assignment of Receivables in International Trade (New York, 12 December 2001).

2. The fact that the parties have their places of business in different States is to be disregarded whenever this fact does not appear either from the contract or from any dealings between the parties or from information disclosed by the parties at any time before or at the conclusion of the contract.

3. Neither the nationality of the parties nor the civil or commercial character of the parties or of the contract is to be taken into consideration in determining the application of this Convention.

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<sup>5</sup> This possibility is provided, for instance, in article 1, paragraph 2, of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit. The Working Group postponed a decision on this subparagraph until it had considered the operative provisions of the draft convention (see A/CN.9/528, paras. 43 and 44). The Working Group may wish to consider whether it should be possible for contracting States to exclude this provision through a declaration made pursuant to draft article X, paragraph 1.

<sup>6</sup> This variant reflects variant 1 of a proposal that was submitted by Germany to the Working Group at its forty-second session (A/CN.9/WG.IV/XLII/CRP.2). Its practical effect would be to limit the applicability of the draft convention only to messages exchanged under the above-mentioned conventions, with the possibility of individual exclusions by contracting States under variant C of draft article Y.

*Article 2. Exclusions*<sup>7</sup>

This Convention does not apply to the use of data messages [in connection with the following contracts, whether existing or contemplated] [in the context of the formation or performance of the following contracts]:

(a) Contracts concluded for personal, family or household purposes [unless the party offering the goods or services, at any time before or at the conclusion of the contract, neither knew nor ought to have known that they were intended for any such use];<sup>8</sup>

[(b) Contracts for the grant of limited use of intellectual property rights];<sup>9</sup>

(c) [*Other exclusions that the Working Group may decide to add.*]<sup>10</sup> [Other matters identified by a Contracting State under a declaration made in accordance with article X].<sup>11</sup>

<sup>7</sup> The last version of this draft article contained two variants reflecting alternative approaches for the treatment of consumer contracts. Variant A excluded consumer contracts by using the same technique that is used in article 2, subparagraph (a), of the United Nations Convention on Contracts for the International Sale of Goods (the “United Nations Sales Convention”). Variant B deferred to domestic law on consumer protection issues, without excluding consumer transactions from the draft convention (see A/CN.9/527, para. 89; see also A/CN.9/528, paras. 51-54). The present version of the draft article retains only the former variant A. The former variant B has been incorporated into draft article 3, as its content is more akin to that article, in its current formulation. The Working Group may wish to bear in mind that the entire draft article may become redundant if the Working Group chooses to define the scope of application of the draft convention along the lines of variant C of draft article 1, since the draft convention would then apply only to the exchange of data messages falling within the scope of those international conventions in accordance with their own rules on their scope of application.

<sup>8</sup> The last phrase is in square brackets, since there was some support at the forty-first session of the Working Group to the suggestion that all the words after “household purposes” should be deleted (see A/CN.9/528, para. 52).

<sup>9</sup> This exclusion is in square brackets as the Working Group has not yet reached an agreement on the matter (see A/CN.9/527, paras. 90-93, and A/CN.9/528, paras. 55-60). The Working Group may wish to note that the International Bureau of the World Intellectual Property Organization sees no need for an exclusion clause with regard to contracts involving intellectual property rights (see A/CN.9/WG.IV/WP.106, para. 2).

<sup>10</sup> This draft article might contain additional exclusions, as may be decided by the Working Group. Annex II of the initial draft (A/CN.9/WG.IV/WP.95) reproduced, for illustrative purposes and without the intention of being exhaustive, exclusions typically found in domestic laws on electronic commerce. Additional exclusions that had been proposed at the fortieth session of the Working Group and reiterated at the forty-first session, related to certain existing financial services markets with well-established rules resulting from specific regulations, standard agreements and practices, system rules or otherwise. Those exclusions included payment systems, negotiable instruments, derivatives, swaps, repurchase agreements (repos), foreign exchange, securities and bond markets, while possibly including general procurement activities of banks and loan activities (see A/CN.9/527, para. 95, and A/CN.9/528, para. 61). Additional exclusions proposed at the forty-first session included “real estate transactions, as well as contracts involving courts or public authorities, family law and the law of succession” (see A/CN.9/528, para. 63). The Working Group may wish to note, in that connection, that the United Nations Commission on International Trade Law (UNCITRAL), at its thirty-sixth session, decided to undertake work in the area of public procurement, including procurement by electronic means (see A/58/17, paras. 225-230). This may render an open-ended exclusion of “contracts involving courts or public authorities” inappropriate.

<sup>11</sup> This phrase is an alternative formulation that would obviate the need for a common list of

*Article 3. Matters not governed by this Convention*<sup>12</sup>

This Convention does not affect or override<sup>13</sup> any rule of law relating to:

[(a) The protection of consumers;]<sup>14</sup>

(b) The validity of the contract or of any of its provisions or of any usage [except as otherwise provided in articles [...]];<sup>15</sup>

(c) The rights and obligations of the parties arising out of the contract or of any of its provisions or of any usage;<sup>16</sup> or

(d) The effect, which the contract may have on, the ownership of rights created or transferred by the contract.<sup>17</sup>

*Article 4. Party autonomy*

The parties may exclude the application of this Convention or derogate from or vary the effect of any of its provisions [except for the following: ...].<sup>18</sup>

**CHAPTER II. GENERAL PROVISIONS**


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exclusions (see A/CN.9/527, para. 96).

<sup>12</sup> The Working Group may wish to bear in mind that the entire draft article may become redundant, if the Working Group chooses to define the scope of application of the draft convention along the lines of variant C of draft article 1, since the draft convention would then apply only to the exchange of data messages falling within the scope of those international conventions in accordance with their own rules on their field of application.

<sup>13</sup> This formulation has been used following a suggestion at the forty-first session of the Working Group that the words previously used ("This Convention is not concerned with") were inaccurate (see A/CN.9/528, para. 67).

<sup>14</sup> Draft subparagraph (a) appears within square brackets, as it represents in some respects an alternative to draft article 2, subparagraph (a) (see A/CN.9/528, para. 52). Under this rule, consumer transactions would not be automatically excluded from the scope of the draft convention, but the provisions of the draft convention would not supersede or affect rules on consumer protection.

<sup>15</sup> Draft subparagraph (b) is derived from article 4, subparagraph (a), of the United Nations Sales Convention. The Working Group may wish to consider the relationship between the general exclusions under the draft article and other provisions that, for instance, affirm the validity of data messages, such as draft articles 8, 9 and 12 (see A/CN.9/527, para. 103).

<sup>16</sup> The preliminary draft convention is not concerned with substantive issues arising out of the contract, which, for all other purposes, remains subject to its governing law (see A/CN.9/527, paras. 10-12). The Working Group may wish to consider whether this provision is still required, since the rule contained in the subparagraph might nevertheless be evident from the limited scope of the draft convention.

<sup>17</sup> Draft subparagraph (d) is based, *mutatis mutandis*, on article 4, subparagraph (b), of the United Nations Sales Convention. Regardless of its final decision on draft articles 1 and Y, the Working Group may wish to consider whether this provision is still required, since the rule contained in the subparagraph might nevertheless be evident from the limited scope of the draft convention.

<sup>18</sup> The Working Group has yet to consider whether some limitation to the principle of party autonomy is appropriate or desirable in the context of the preliminary draft convention, in particular in the light of provisions such as draft articles 9, paragraph 3, 11 and 15 (see A/CN.9/527, para. 109; see also A/CN.9/528, paras. 71-75). The earlier version of this article contained a second paragraph dealing with the agreement of the parties to the use of data messages in a contractual context. That provision has now been combined with draft article 8.



*Article 5. Definitions*<sup>19</sup>

For the purposes of this Convention:

(a) “Data message” means information generated, sent, received or stored by electronic, optical or similar means including, but not limited to, electronic data interchange (EDI), electronic mail, telegram, telex or telecopy;

(b) “Electronic data interchange (EDI)” means the electronic transfer from computer to computer of information using an agreed standard to structure the information;

(c) “Originator” of a data message means a person by whom, or on whose behalf, the data message purports to<sup>20</sup> have been sent or generated prior to storage, if any, but it does not include a person acting as an intermediary with respect to that data message;

(d) “Addressee” of a data message means a person who is intended by the originator to receive the data message, but does not include a person acting as an intermediary with respect to that data message;

(e) “Information system” means a system for generating, sending, receiving, storing or otherwise processing data messages;<sup>21</sup>

(f) “Automated information system” means a computer program or an electronic or other automated means used to initiate an action or respond to data messages or performances in whole or in part, without review or intervention by a natural person each time an action is initiated or a response is generated by the system;<sup>22</sup>

[(g) “Electronic signature” means data in electronic form in, affixed to, or logically associated with, a data message, which may be used to identify the person holding the signature creation data in relation to the data message and indicate that person’s approval of the information contained in the data message;<sup>23</sup>

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<sup>19</sup> The definitions contained in draft paragraphs (a) to (e) are derived from article 2 of the UNCITRAL Model Law on Electronic Commerce. The definition of “electronic signature” corresponds to the definition of the same expression in article 2 of the UNCITRAL Model Law on Electronic Signatures. The definitions of “offeror” and “offeree” have been deleted, although the Working Group had tentatively retained them (see A/CN.9/527, para. 115). The Secretariat submits that those words have become superfluous in view of the reformulation of draft articles 8 and 13 (see A/CN.9/528, para. 106).

<sup>20</sup> The wording of this definition is taken from article 2, subparagraph (c), of the UNCITRAL Model Law on Electronic Commerce. It has been suggested to the Secretariat that it might be preferable to delete the words “purports to have been sent” and use instead the words “has been sent”.

<sup>21</sup> The Working Group may wish to consider whether this definition needs further clarification, in view of the questions that have been raised in connection with paragraph 2 of the former article 11 (currently article 10) (see A/CN.9/528, paras. 148 and 149, and A/CN.9/546, paras. 59-80).

<sup>22</sup> This definition is based on the definition of “electronic agent” contained in section 2, paragraph 6, of the Uniform Electronic Transactions Act of the United States of America; a similar definition is also used in section 19 of the Uniform Electronic Commerce Act of Canada. This definition was included in view of the contents of draft article 14.

<sup>23</sup> The initial draft contained in document A/CN.9/WG.IV/WP.95 included, as a variant to this provision, a general definition of “signature”. Although the Working Group tentatively agreed

[(h) “Place of business”<sup>24</sup> means [any place of operations where a person carries out a non-transitory activity with human means and goods or services;]<sup>25</sup> [the place where a party maintains a stable establishment to pursue an economic activity other than the temporary provision of goods or services out of a specific location;]<sup>26</sup>]

[(i) “Person” and “party” include natural persons and legal entities;]<sup>27</sup>

[(j) Other definitions that the Working Group may wish to add.]<sup>28</sup>

#### *Article 6. Interpretation*

1. In the interpretation of this Convention, regard is to be had to its international character and to the need to promote uniformity in its application and the observance of good faith in international trade.

2. Questions concerning matters governed by this Convention which are not expressly settled in it are to be settled in conformity with the general principles on which it is based or, in the absence of such principles, in conformity with the law applicable [by virtue of the rules of private international law].<sup>29</sup>

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on retaining both variants, the Secretariat suggests that it might be more appropriate, given the limited scope of the draft convention, to define only “electronic signatures”, leaving a definition of “signature” for the otherwise applicable law, as had been suggested at the fortieth session of the Working Group (see A/CN.9/527, paras. 116-119).

<sup>24</sup> The proposed definition appears within square brackets since the Commission has not thus far defined “place of business” (see A/CN.9/527, paras. 120-122). At the thirty-ninth session of the Working Group, it was suggested that the rules on the location of the parties should be expanded to include elements such as the place of an entity’s organization or incorporation (see A/CN.9/509, para. 53). The Working Group decided that it could consider the desirability of using supplementary elements to the criteria used to define the location of the parties by expanding the definition of place of business (see A/CN.9/509, para. 54). The Working Group may wish to consider whether the proposed additional notions and any other new elements should be provided as an alternative to the elements currently used or only as a default rule for those entities without an “establishment”. Additional cases that might deserve consideration by the Working Group might include situations where the most significant component of human means or goods or services used for a particular business are located in a place bearing little relationship to the actual centre of a company’s affairs, such as when the only equipment and personnel used by a so-called “virtual business” located in one country consists of leased space in a third-party server located elsewhere.

<sup>25</sup> This alternative reflects the essential elements of the notions of “place of business”, as understood in international commercial practice, and “establishment”, as used in article 2, subparagraph (f), of the UNCITRAL Model Law on Cross-Border Insolvency.

<sup>26</sup> This alternative follows the understanding of the concept of “place of business” in the European Union (see para. 19 of the preamble to Directive 2000/31/EC of the European Union).

<sup>27</sup> During the preparation of the UNCITRAL Model Law on Electronic Commerce, it was felt that such a definition did not belong in the text of the instrument, but in its guide to enactment. As a convention would not normally be accompanied by extensive comments, the proposed definition has been included in the form of a provision, should the Working Group find such a definition necessary, particularly in view of provisions such as draft article 9, variant B, subparagraph 4 (b).

<sup>28</sup> The Working Group may wish to consider whether definitions of other terms should be included, such as “signatory” (if variant B of draft article 10 (formerly 14) is adopted), “interactive applications”, “electronic mail” or “domain name”.

<sup>29</sup> The closing phrase has been placed in square brackets at the request of the Working Group.

*Article 7. Location of the parties*<sup>30</sup>

1. For the purposes of this Convention, a person's place of business is presumed to be the location indicated by that person [, unless the person does not have a place of business at such location [[and] such indication is made solely to trigger or avoid the application of this Convention]].

2. If a person [has not indicated a place of business or, subject to paragraph 1 of this article, a person]<sup>31</sup> has more than one place of business, the place of business for the purposes of this Convention is that which has the closest relationship to the relevant contract and its performance, having regard to the circumstances known to or contemplated by the parties at any time before or at the conclusion of the contract.

3. If a person does not have a place of business, reference is to be made to the person's habitual residence.

4. The place of location of the equipment and technology supporting an information system used by a person in connection with the formation of a contract or the place from which such information system may be accessed by other persons, in and of themselves, do not constitute a place of business [, unless such legal entity does not have a place of business [within the meaning of article 5 (h)]].<sup>32</sup>

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Similar formulations in other instruments had been incorrectly understood as allowing immediate referral to the applicable law pursuant to the rules on conflict of laws of the forum State for the interpretation of a convention without regard to the conflict of laws rules contained in the convention itself (see A/CN.9/527, paras. 125 and 126).

<sup>30</sup> The draft paragraph is not intended to create a new concept of "place of business" for the online world. The phrase in square brackets aims to prevent a party from benefiting from recklessly inaccurate or untruthful representations (see A/CN.9/509, para. 49), but not to limit the parties' ability to choose the Convention or otherwise agree on the applicable law. The two variants previously contained in the draft paragraph have been combined as the Working Group preferred the former variant A (see A/CN.9/528, para. 88). The words "manifest and clear" which the Working Group found to be conducive to legal uncertainty (see A/CN.9/528, para. 86), have been deleted.

<sup>31</sup> It has been suggested to the Secretariat that the presumption contemplated in the draft article could also apply in the event that a party does not indicate its place of business. This suggestion has been inserted in square brackets, since the presumption contemplated in the draft article has been used in other UNCITRAL instruments only in connection with multiple places of business.

<sup>32</sup> The draft paragraph reflects the principle that rules on location should not result in any given party being considered as having its place of business in one country when contracting electronically and in another country when contracting by more traditional means (see A/CN.9/484, para. 103). The draft paragraph follows the solution proposed in paragraph 19 of the preamble to Directive 2000/31/EC of the European Union (see also the overview of issues related to the location of information systems in A/CN.9/WG.IV/WP.104, paras. 9-17). The phrase within square brackets is only intended to deal with so-called "virtual companies" and not with natural persons, who are covered by the rule contained in draft paragraph 3. The Working Group may wish to consider whether draft paragraphs 4 and 5, which the Working Group agreed to retain for further consideration, should be combined in one provision (see A/CN.9/509, para. 59).

5. The sole fact that a person makes use of a domain name or electronic mail address connected to a specific country does not create a presumption that its place of business is located in such country.<sup>33</sup>

*Article 7 bis [II]. Information requirements*

Nothing in this Convention affects the application of any rule of law that may require the parties to disclose their identities, places of business or other information, or relieves a party from the legal consequences of making inaccurate or false statements in that regard.

**CHAPTER III. USE OF DATA MESSAGES IN INTERNATIONAL CONTRACTS**

*Article 8. Legal recognition of data messages*

1. Where a communication, declaration, demand, notice or request that the parties are required to make or choose to make in connection with an existing or contemplated contract, including an offer and the acceptance of an offer, is conveyed by means of data messages, such communication, declaration, demand, notice or request shall not be denied validity or enforceability on the sole ground that data messages were used for that purpose.

[2. Nothing in this Convention requires a person to use or accept information in the form of data messages, but a person's agreement to use or accept information in the form of data messages may be inferred from the person's conduct.]<sup>34</sup>

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<sup>33</sup> The current system for assignment of domain names was not originally conceived in geographical terms. Therefore, the apparent connection between a domain name and a country is often insufficient to conclude that there is a genuine and permanent link between the domain name user and the country (see A/CN.9/509, paras. 44-46; see also A/CN.9/WG.IV/WP.104, paras. 18-20). However, in some countries the assignment of domain names is only made after verification of the accuracy of the information provided by the applicant, including its location in the country to which the relevant domain name relates. For those countries, it might be appropriate to rely, at least in part, on domain names for the purpose of article 7, contrary to what is suggested in the draft paragraph (see A/CN.9/509, para. 58). The Working Group may wish to consider whether the proposed rules should be expanded to deal with those situations.

<sup>34</sup> The provision reflects the idea that parties should not be forced to accept contractual offers or acts of acceptance by electronic means if they do not want to do so (see A/CN.9/527, para. 108). However, since the provision is not intended to require that the parties should always agree beforehand on the use of data messages, the second phrase provides that a party's agreement to transact electronically may be inferred from its conduct. The reference to "consent" has been replaced with the phrase "a person's agreement to use or accept information in the form of data messages" so as to avoid the erroneous impression that the draft paragraph refers to consent to the underlying transaction (see A/CN.9/546, para. 43).

*Article 9. Form requirements*

[1. Nothing in this Convention requires a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make in connection with an existing or contemplated contract to be made or evidenced in any particular form.]<sup>35</sup>

2. Where the law requires that a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make in connection with a contract should be in writing, that requirement is met by a data message if the information contained therein is accessible so as to be usable for subsequent reference.<sup>36</sup>

3. Where the law requires that a contract or any other communication, declaration, demand, notice or request that the parties are required to make or choose to make in connection with a contract should be signed, or provides consequences for the absence of a signature, that requirement is met in relation to a data message if:

(a) A method is used to identify that person and to indicate that person's approval of the information contained in the data message; and

(b) That method is as reliable as appropriate to the purpose for which the data message was generated or communicated, in the light of all the circumstances, including any relevant agreement.<sup>37</sup>

*Article 10. Time and place of dispatch and receipt of data messages*<sup>38</sup>

1. The time of dispatch of a data message is the time when the data message [enters an information system outside the control of the originator or of the person who sent the data message on behalf of the originator] [leaves an information system under the control of the originator or of the person who sent the data message on behalf of the originator], or, if the message had not [entered an information system outside the control of the originator or of the person who sent the data message on behalf of the originator] [left an information system under the

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<sup>35</sup> This provision incorporates the general principle of freedom of form contained in article 11 of the United Nations Sales Convention, in the manner suggested at the forty-second session of the Working Group (see A/CN.9/546, para. 49).

<sup>36</sup> This provision sets forth the criteria for the functional equivalence between data messages and paper documents, in the same manner as article 6 of the UNCITRAL Model Law on Electronic Commerce. The Working Group may wish to consider the meaning of the words "the law" and "writing" and whether there would be a need for including definitions of those terms (see A/CN.9/509, paras. 116 and 117).

<sup>37</sup> The draft paragraph recites the general criteria for the functional equivalence between handwritten signatures and electronic identification methods referred to in article 7 of the UNCITRAL Model Law on Electronic Commerce.

<sup>38</sup> Earlier versions of the draft article followed more closely the formulation of article 15 of the UNCITRAL Model Law on Electronic Commerce, with some adjustments to harmonize the style of the individual provisions with the style used elsewhere in the draft convention. The current formulation reflects the deliberations of the Working Group at its forty-second session (see A/CN.9/546, paras. 59-86). The Working Group may wish to review the new formulation, in particular draft paragraph 2, with a view to ensuring that it is consistent in result with article 15 of the Model Law.

control of the originator or of the person who sent the data message on behalf of the originator], at the time when the message is received.

2. The time of receipt of a data message is the time when the data message becomes capable of being retrieved by the addressee or by any other person named by the addressee. A data message is presumed to be capable of being retrieved by the addressee when the data message enters an information system of the addressee unless it was unreasonable for the originator to have chosen that particular information system for sending the data message, having regard to the circumstances of the case and the content of the data message.

3. A data message is deemed to be dispatched at the place where the originator has its place of business and is deemed to be received at the place where the addressee has its place of business, as determined in accordance with article 7.

4. Paragraph 2 of this article applies notwithstanding that the place where the information system is located may be different from the place where the data message is deemed to be received under paragraph 3 of this article.

*Article 11 [12]. Invitations to make offers<sup>39</sup>*

A proposal to conclude a contract made through one or more data messages which is not addressed to one or more specific persons, but is generally accessible to parties making use of information systems, including proposals that make use of interactive applications<sup>40</sup> for the placement of orders through such information system, is to be considered as an invitation to make offers, unless it clearly indicates the intention of the person making the proposal to be bound in case of acceptance.

*Article 12 [14]. Use of automated information systems for contract formation<sup>41</sup>*

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<sup>39</sup> This provision deals with an issue that has given rise to extensive debate. At the forty-first session of the Working Group, it was noted that “there was currently no standard business practice in that area” (see A/CN.9/528, para. 117). The current text is inspired by article 14, paragraph 1, of the United Nations Sales Convention and affirms the principle that proposals to conclude a contract that are addressed to an unlimited number of persons are not binding offers, even if they involve the use of interactive applications. The Working Group may wish to consider, however, whether specific rules should be formulated to deal with offers of goods through Internet auction platforms and similar transactions, which in many legal systems have been regarded as binding offers to sell the goods to the highest bidder.

<sup>40</sup> At its forty-second session, the Working Group noted that the expression “automated information system”, which had been used in earlier versions of the draft article, did not offer meaningful guidance since the party that placed an order might have no means of knowing how the order would be processed and to what extent the information system was automated. The notion of “interactive applications”, in turn, was considered to be an objective term that better described a situation apparent to any person accessing the system, namely that it was prompted to exchange information through that system by means of immediate actions and responses having an appearance of automaticity. It was noted that the term was not a legal term but rather a term of art highlighting that the provision focused on what was apparent to the party activating the system rather than on how the system functioned internally. On that basis, the Working Group agreed that the term “interactive applications” could be retained (see A/CN.9/546, para. 114).

<sup>41</sup> This article has been redrafted as a non-discrimination rule, as requested by the Working Group at its forty-second session (see A/CN.9/546, paras. 128 and 129). The Working Group may wish to consider whether the provision should be supplemented by a general provision on attribution

A contract formed by the interaction of an automated information system and a person, or by the interaction of automated information systems, shall not be denied validity or enforceability on the sole ground that no person reviewed each of the individual actions carried out by such systems or the resulting agreement.

*[Article 13 [15]. Availability of contract terms*

[Variant A<sup>42</sup>

Nothing in this convention affects the application of any rule of law that may require a party that negotiates a contract through the exchange of data messages to make available to the other contracting party the data messages that contain the contractual terms in a particular manner, or relieves a party from the legal consequences of its failure to do so.]

[Variant B<sup>43</sup>

A party offering goods or services through an information system that is generally accessible to persons making use of information systems<sup>44</sup> shall make the data message or messages which contain the contract terms<sup>45</sup> available to the other party [for a reasonable period of time] in a way that allows for its or their storage and reproduction.]

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of data messages, including attribution of data messages exchanged by automated information systems (see A/CN.9/546, paras. 85, 86 and 125-127).

<sup>42</sup> This variant has been added pursuant to a request by the Working Group in view of the controversy around the draft article (see A/CN.9/546, paras. 130-135). If this variant alone is retained, the Working Group may wish to consider placing the draft article in chapter I or II of the draft convention or even combining it with the current draft article 3.

<sup>43</sup> This variant, which is based on article 10, paragraph 3, of Directive 2000/31/EC of the European Union, appears in square brackets, as there was no consensus on the need for the provision within the Working Group (see A/CN.9/509, paras. 123-125, and A/CN.9/546, paras. 130-135). If the provision is retained, the Working Group may wish to consider whether the draft article should provide consequences for the failure by a party to make available the contract terms and what consequences would be appropriate. In some legal systems the consequences might be that a contractual term that has not been made available to the other party cannot be enforced against it.

<sup>44</sup> The Working Group may wish to consider whether these words adequately describe the types of situations that the Working Group intends to address in the draft article.

<sup>45</sup> The words “and general conditions” have been deleted as they appeared to be redundant. The Working Group may, however, wish to consider whether the provision should be made more explicit as to the version of the contract terms that needs to be retained.

*Article 14 [16]. Error in electronic communications*Variant A<sup>46</sup>

[Unless otherwise [expressly] agreed by the parties,]<sup>47</sup> a contract concluded by a person that accesses an automated information system of another party has no legal effect and is not enforceable if the person made an error in a data message and:<sup>48</sup>

(a) The automated information system did not provide the person with an opportunity to prevent or correct the error;

(b) The person notifies the other party of the error as soon as practicable when the person making the error learns of it and indicates that he or she made an error in the data message;

[(c) The person takes reasonable steps, including steps that conform to the other party's instructions, to return the goods or services received, if any, as a result of the error or, if instructed to do so, to destroy such goods or services; and

[(d) The person has not used or received any material benefit or value from the goods or services, if any, received from the other party.]<sup>49</sup>

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<sup>46</sup> This draft paragraph deals with the issue of errors in automated transactions (see A/CN.9/WG.IV/WP.95, paras. 74-79). Earlier versions of the draft article contained, in paragraph 1 of variant A, a rule based on article 11, paragraph 2, of Directive 2000/31/EC of the European Union, which creates an obligation for persons offering goods or services through automated information systems to offer means for correcting input errors, and required such means to be "appropriate, effective and accessible". The draft article was the subject of essentially two types of objections: one objection was that the draft convention should not deal with a complex substantive issue such as error and mistake, a matter on which the Working Group has not yet reached a final decision; another objection was that the obligations contemplated in article 14, paragraph 2, of the first version of the draft convention (as contained in A/CN.9/WG.IV/WP.95) were regarded as being of a regulatory or public law nature (see A/CN.9/509, para. 108). The Working Group may wish to consider whether the latter objection could be addressed by deleting the reference to an obligation to provide means for correcting errors and by contemplating only private law consequences for the absence of such means.

<sup>47</sup> The Working Group may wish to consider whether the possibility of derogation by agreement needs to be expressly made or can result from tacit agreement, for instance when a party proceeds to place an order through the seller's automated information system even though it is apparent to such party that the system does not provide an opportunity to correct input errors.

<sup>48</sup> This provision deals with the legal effects of errors made by a natural person communicating with an automated information system. The draft provision is inspired by section 22 of the Uniform Electronic Commerce Act of Canada. At the thirty-ninth session of the Working Group it was suggested that such provisions might not be appropriate in the context of commercial (that is, non-consumer) transactions, since the right to repudiate a contract in case of material error may not always be provided under general contract law. The Working Group nevertheless decided to retain it for further consideration (see A/CN.9/509, paras. 110 and 111).

<sup>49</sup> Subparagraphs (c) and (d) appear within square brackets since it was suggested, at the thirty-ninth session of the Working Group, that the matters dealt with therein went beyond matters of contract formation and departed from the consequences of avoidance of contracts under some legal systems (see A/CN.9/509, para. 110).



## Variant B

1. [Unless otherwise [expressly] agreed by the parties,]<sup>50</sup> a contract concluded by a person that accesses an automated information system of another party has no legal effect and is not enforceable if the person made an error in a data message and the automated information system did not provide the person with an opportunity to prevent or correct the error. The person invoking the error must notify the other party of the error as soon as practicable and indicate that he or she made an error in the data message.<sup>51</sup>

[2. A person is not entitled to invoke an error under paragraph 1:

(a) If the person fails to take reasonable steps, including steps that conform to the other party's instructions, to return the goods or services received, if any, as a result of the error or, if instructed to do so, to destroy such goods or services; or

(b) If the person has used or received any material benefit or value from the goods or services, if any, received from the other party.]<sup>52</sup>

[Other substantive provisions that the Working Group may wish to include.]<sup>53</sup>

**CHAPTER IV. FINAL PROVISIONS***[Article X. Declarations on exclusions]<sup>54</sup>*

1. Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will not be bound by subparagraph 1 (b) of article 1 of this Convention.]<sup>55</sup>

2. Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will not apply this Convention to the matters specified in its declaration.

3. Any declaration made pursuant to paragraphs 1 and 2 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.]

<sup>50</sup> See note 47.

<sup>51</sup> This variant combines in two paragraphs the various elements contained in paragraphs 2 and 3 and subparagraphs (a)-(d) of the first version of the draft article (see A/CN.9/WG.IV/WP.95), as requested by the Working Group (see A/CN.9/509, para. 111).

<sup>52</sup> See footnote 49.

<sup>53</sup> Such additional provisions might include, beyond consequences for a person's failure to comply with draft articles 11, 15 and 16, an issue that the Working Group has not yet considered (see A/CN.9/527, para. 103), other issues dealt with in electronic commerce legislation, such as liability of information services providers for loss or delay in the delivery of data messages.

<sup>54</sup> The Working Group has not yet concluded its deliberations on possible exclusions to the preliminary draft convention under draft article 2 (see A/CN.9/527, paras. 83-98). The draft article has been added as a possible alternative, in the event that consensus is not achieved on possible exclusions to the preliminary draft convention.

<sup>55</sup> At its forty-first session, the Working Group agreed to consider, at a later stage, a provision allowing contracting States to exclude the application of subparagraph (b) of article 1, paragraph 1, along the lines of article 95 of the United Nations Sales Convention (see A/CN.9/528, para. 42).

*Article Y. Communications exchanged under other international conventions*<sup>56</sup>Variant A<sup>57</sup>

1. Except as otherwise stated in a declaration made in accordance with paragraph 2 of this article, a State Party to this Convention [may declare at any time that it]<sup>58</sup> undertakes to apply the provisions of [article 7 and ] chapter III<sup>59</sup> of this Convention to the exchange [by means of data messages] of any communications, declarations, demands, notices or requests [, including an offer and acceptance of an offer,] that the parties are required to make or choose to make in connection with or under any of the following international agreements or conventions to which the State is or may become a Contracting State:

Convention on the Limitation Period in the International Sale of Goods (New York, 14 June 1974) and Protocol thereto (Vienna, 11 April 1980)

United Nations Convention on Contracts for the International Sale of Goods (Vienna, 11 April 1980)

United Nations Convention on the Liability of Operators of Transport Terminals in International Trade (Vienna, 17 April 1991)

United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (New York, 11 December 1995)

<sup>56</sup> The draft article is intended to offer a possible common solution for some of the legal obstacles to electronic commerce under existing international instruments, which had been the object of a survey contained in an earlier note by the Secretariat (see A/CN.9/WG.IV/WP.94). At the fortieth session of the Working Group, there was general agreement to proceed in that manner, to the extent that the issues were common, which was the case at least with regard to most issues raised under the instruments listed in variant A (see A/CN.9/527, paras. 33-48). If either variant B or variant C is adopted, the title of the draft article would need to be changed to "reservations".

<sup>57</sup> This variant is intended to remove doubts as to the relationship between the rules contained in the draft convention and rules contained in other international conventions. It is not the purpose of this variant effectively to amend or otherwise affect the application of any other international convention. In practice, the draft article would have the effect of an undertaking by a contracting State to use the provisions of the draft convention to remove possible legal obstacles to electronic commerce that might arise under those conventions and to facilitate their application in cases where the parties conduct their transactions through electronic means.

<sup>58</sup> The language in square brackets is intended to give more flexibility in the application of the draft article, since, without such clarification, the provision might be read to the effect that an undertaking pursuant to the draft article needed to be assumed upon signature, ratification or accession and could not be expanded at a later stage. If these words are retained, a provision along the lines of paragraph 3 of draft article X may be needed also in draft article Y.

<sup>59</sup> The specific reference to the substantive provisions of the draft convention contained in chapter III is intended to avoid the impression that the provisions on the scope of application of the draft convention would affect the definition of the scope of application of other international conventions. The Working Group may wish to consider whether the provisions of draft article 7, to which reference is made in square brackets, are also suitable for subsidiary (interpretative) application in the context of other international conventions, or whether they might interfere with the existing interpretation of those conventions.

United Nations Convention on the Assignment of Receivables in International Trade (New York, 12 December 2001).

[2. Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will also apply this Convention to the exchange by means of data messages of any communications, declarations, demands, notices or requests under any other international agreement or convention on private commercial law matters to which the State is a Contracting State and which are identified in that State's declaration.]<sup>60</sup>

3. Any State may declare at any time that it will not apply this Convention [or any specific provision thereof] to international contracts falling within the scope of [any of the above conventions.] [one or more international agreements, treaties or conventions to which the State is a Contracting Party and which are identified in that State's declaration.]

4. Any declaration made pursuant to paragraphs 1 and 2 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.

#### Variant B<sup>61</sup>

1. Any State may at any time make a reservation to the effect that it shall apply this Convention [or any specific provision thereof] only to data messages in connection with an existing or contemplated contract to which, pursuant to the law of that State, a specific international convention clearly identified in the reservation made by that State is to be applied.

2. Any declaration made pursuant to paragraph 1 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.

#### Variant C<sup>62</sup>

1. Any State may declare at any time that it will not apply this Convention [or any specific provision thereof] to data messages in connection with an existing or contemplated contract to which one or more of the international conventions referred to in article 1, paragraph 1, are to be

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<sup>60</sup> Paragraph 1 of variant A is intended to make it clear that the provisions of the draft convention apply also to messages exchanged under any of the international conventions referred to therein. Paragraph 2 contemplates the possibility for a contracting State to extend the application of the new instrument to the use of data messages in the context of other international conventions.

<sup>61</sup> This variant reflects variant 2 of a proposal that was submitted by Germany at the forty-second session of the Working Group (see A/CN.9/WG.IV/XLII/CRP.2). It is logically related to variant A of draft article 1. Its practical effect would be to limit the applicability of the draft convention only to messages exchanged under conventions specifically identified by contracting States.

<sup>62</sup> This variant reflects variant 1 of a proposal that was submitted by Germany at the forty-second session of the Working Group (see A/CN.9/WG.IV/XLII/CRP.2). It is included in the event that the Working Group chooses variant B of draft article 1, so as to give the contracting States the possibility to exclude the application of the draft convention in respect of certain specific conventions.

applied, provided that the relevant conventions shall be clearly identified in the declaration made by that State.

2. Any declaration made pursuant to paragraph 1 of this article shall take effect on the first day of the month following the expiration of [six] months after the date of its receipt by the depositary.

*[Customary and other final clauses that the Working Group may wish to include.]*

## V. SECURITY INTERESTS

### A. Report of the Working Group on Security Interests on the work of its fourth session (Vienna, 8 - 12 September 2003)

(A/CN.9/543) [original: English]

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## I. Introduction

1. At its present session, the Working Group continued its work on the development of “an efficient legal regime for security rights in goods involved in a commercial activity”.<sup>1</sup> The Commission’s decision to undertake work in the area of secured credit law was taken in response to the need for an efficient legal regime that would remove legal obstacles to secured credit and could thus have a beneficial impact on the availability and the cost of credit.<sup>2</sup>

<sup>1</sup> *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 (A/56/17)*, para. 358.

<sup>2</sup> *Ibid.*, *Fifty-fifth Session, Supplement No. 17 (A/55/17)*, para. 455, and *Fifty-sixth Session, Supplement No. 17 (A/56/17)*, para. 347.

2. At its thirty-third session (2000), the Commission discussed a report prepared by the Secretariat on issues to be addressed in the area of secured credit law (A/CN.9/475). At that session, the Commission agreed that secured credit law was an important subject and had been brought to the attention of the Commission at the right time, in particular in view of its close link with the work of the Commission on insolvency law. It was widely felt that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade. It was also widely felt that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries, and in the share such parties had in the benefits of international trade. A note of caution was struck, however, in that regard to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States. Furthermore, it was stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, would be advisable.<sup>3</sup>

3. At its thirty-fourth session (2001), the Commission considered another report prepared by the Secretariat (A/CN.9/496) and agreed that work should be undertaken in view of the beneficial economic impact of a modern secured credit law. It was stated that experience had shown that deficiencies in that area could have major negative effects on a country's economic and financial system. It was also stated that an effective and predictable legal framework had both short- and long-term macroeconomic benefits. In the short term, namely, when countries faced crises in their financial sector, an effective and predictable legal framework was necessary, in particular in terms of enforcement of financial claims, to assist banks and other financial institutions in controlling the deterioration of their claims through quick enforcement mechanisms and to facilitate corporate restructuring by providing a vehicle that would create incentives for interim financing. In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential.<sup>4</sup> As to the form of work, the Commission considered that a model law would be too rigid and noted the suggestions made for a set of principles with a legislative guide that would include legislative recommendations.<sup>5</sup>

4. At its first session (New York, 20-24 May 2002), the Working Group considered chapters I to V and X (A/CN.9/WG.VI/WP.2 and Addenda 1 to 5 and 10) of the first preliminary draft guide on secured transactions, prepared by the Secretariat. At that session, the Working Group requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/512, para. 12). At that session, the Working Group also considered suggestions for the presentation of modern registration systems in order to provide the Working Group with information necessary to address concerns expressed with respect to registration of security rights in movable property (see A/CN.9/512, para. 65). At the same session, the

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<sup>3</sup> Ibid., *Fifty-fifth Session, Supplement No. 17* (A/55/17), para. 459.

<sup>4</sup> Ibid., *Fifty-sixth Session, Supplement No. 17* (A/56/17), para. 351.

<sup>5</sup> Ibid., para. 357.

Working Group agreed on the need for coordination with Working Group V (Insolvency Law) on matters of common interest and endorsed the conclusions of Working Group V with respect to those matters (see A/CN.9/512, para. 88).

5. At its thirty-fifth session (2002), the Commission considered the report of the first session of the Working Group (A/CN.9/512). It was widely felt that the legislative guide represented a valuable opportunity for the Commission to assist States in adopting modern secured transactions legislation, which was generally thought to be a necessary, albeit not sufficient in itself, condition for increasing access to low-cost credit, thus facilitating the cross-border movement of goods and services, economic development and ultimately friendly relations among nations. In that connection, the Commission noted with satisfaction that the project had attracted the attention of international, governmental and non-governmental organizations and that some of those took an active part in the deliberations of the Working Group. At that session, the Commission also felt that the timing of the Commission's initiative was most opportune both in view of the relevant legislative initiatives under way at the national and international levels and in view of the Commission's own initiative in the field of insolvency law. After discussion, the Commission confirmed the mandate given to the Working Group at its thirty-fourth session to develop an efficient legal regime for security rights in goods, including inventory. The Commission also confirmed that the mandate of the Working Group should be interpreted widely to ensure an appropriately flexible work product, which should take the form of a legislative guide.<sup>6</sup>

6. At its second session (Vienna, 17-20 December 2002), the Working Group considered chapters VI, VII and IX (A/CN.9/WG.VI/WP.2 and Addenda 6, 7 and 9) of the first preliminary draft guide on secured transactions, prepared by the Secretariat. At that session, the Working Group requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/531, para. 15). In conjunction with that session and in accordance with suggestions made at the first session of the Working Group (see A/CN.9/512, para. 65), an informal presentation of the registration systems of security rights in movable property of New Zealand and Norway was held. Immediately before that session, Working Groups V (Insolvency Law) and VI (Security Interests) held their first joint session (Vienna, 16-17 December 2002), during which the revised version of former chapter X (new chapter IX; A/CN.9/WG.VI/WP.6/Add.5) on insolvency was considered. At that session, the Secretariat was requested to prepare a revised version of that chapter (see A/CN.9/535, para. 8).

7. At its third session (New York, 3-7 March 2003), the Working Group considered chapters VIII, XI and XII of the first preliminary draft guide on secured transactions (A/CN.9/WG.VI/WP.2/Add.8, A/CN.9/WG.VI/WP.2/Add.11 and A/CN.9/WG.VI/WP.2/Add.12) and chapters II and III (paras. 1-33) of the second version of the draft guide (A/CN.9/WG.VI/WP.6/Add.2 and A/CN.9/WG.VI/WP.6/Add.3) and requested the Secretariat to prepare revised versions (A/CN.9/532, para. 13).

8. At its thirty-sixth session in 2003, the Commission had before it the reports of Working Group VI (Security Interests) on the work of its second and third sessions

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<sup>6</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17* (A/57/17), paras. 202-204.



(A/CN.9/531 and A/CN.9/532), as well as the report of the first joint session of Working Group V and VI (A/CN.9/535). The Commission noted with appreciation the progress made by the Working Group in its work.<sup>7</sup>

## II. Organization of the session

9. The Working Group, which was composed of all States members of the Commission, held its fourth session in Vienna from 8 to 12 September 2003. The session was attended by representatives of the following States members of the Commission: Austria, Benin, Brazil, Burkina Faso, Cameroon, Canada, China, Colombia, Fiji, France, Germany, Honduras, Hungary, India, Iran (Islamic Republic of), Italy, Japan, Kenya, Lithuania, Mexico, Morocco, Paraguay, Romania, Russian Federation, Rwanda, Sierra Leone, Singapore, Spain, Sudan, Sweden, Thailand, the Former Yugoslav Republic of Macedonia, United Kingdom of Great Britain and Northern Ireland, United States of America and Uruguay (alternating annually with Argentina).

10. The session was attended by observers from the following States: Argentina, Australia, Costa Rica, Côte d'Ivoire, Czech Republic, Ghana, Indonesia, Lebanon, Libyan Arab Jamahiriya, Nigeria, Peru, Poland, Republic of Korea, Switzerland, Turkey, Ukraine and Venezuela.

11. The session was also attended by observers from the following national or international organizations: (a) organizations of the United Nations system: International Monetary Fund (IMF), the World Bank; (b) intergovernmental organizations: Asian Clearing Union; National Law Center for Inter-American Free Trade (NLCIFT); (c) non-governmental organizations invited by the Commission: American Bar Association (ABA), Center for International Legal Studies, Commercial Finance Association (CFA), Europafactoring, International Chamber of Commerce (ICC), International Federation of Insolvency Professionals (INSOL) and Max-Planck-Institute of Foreign and Private International Law.

12. The Working Group elected the following officers:

*Chairman:* Ms. Kathryn SABO (Canada)

*Rapporteur:* Mr. Norbert Csizmazia (Hungary)

13. The Working Group had before it the following documents: A/CN.9/WG.VI/WP.8 (provisional agenda), A/CN.9/WG.VI/WP.6 and Addenda 1, 3, as well as A/CN.9/WG.VI/WP.9 and Addenda 1 to 4 and 6 to 8 .

14. The Working Group adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Preparation of a legislative guide on secured transactions.
4. Other business.
5. Adoption of the report.

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<sup>7</sup> Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), paras. 215-222.

### **III. Deliberations and decisions**

15. The Working Group considered chapters IV (Creation), IX (Insolvency), I (Introduction), II (Key Objectives), and paragraphs 1 to 41 of chapter VII (Priority of the draft guide). The deliberations and decisions of the Working Group are set forth below in part IV. The Secretariat was requested to prepare, on the basis of those deliberations and decisions, a revised version of the chapters of the draft guide discussed at this session.

## **IV. Preparation of a legislative guide on secured transactions**

### **Chapter IV. Creation (A/CN.9/WG.VI/WP.6/Add.3)**

#### **A. Enterprise mortgages and floating charges (paras. 27-33)**

16. Recalling that, at its third session, it had considered paragraphs 1 to 33 of chapter IV (see A/CN.9/532, para. 108), the Working Group resumed its deliberations on the issue of enterprise mortgages.

17. The Working Group agreed that the section should be revised to provide a balanced outline of the advantages and disadvantages of the enterprise mortgage concept. It was stated that the main advantage of an enterprise mortgage type of security right was that it allowed an enterprise that had more value as a whole to obtain more credit and at a lower cost. On the other hand, it was observed that an enterprise mortgage might limit the ability of the debtor to obtain credit from other sources and raise the cost of that credit to the extent that other creditors were unprotected. It was said, in some countries, limitations had been introduced to the scope of enterprise mortgages, in terms of a percentage at the value of the enterprise, in the case of insolvency. In response, it was observed that the economic impact and the placement of any such limitations in the draft guide should be carefully considered. It was also stated that any limitations should be part of insolvency law and discussed in the draft guide on Insolvency Law and in the chapter on Insolvency of the draft guide on Secured Transactions.

18. With regard to the note following paragraph 33, there was general agreement in the Working Group that the appointment of an administrator could be made by agreement between the debtor and the secured creditor or by a court. It was suggested that such appointment could also be made by the debtor. It was agreed that appointment of an administrator related to enforcement in and outside of an insolvency proceeding and, while reference should be made in the chapter on Creation to the ability of the parties to a security agreement to agree to the appointment of an administrator in the enforcement of an enterprise mortgage outside of insolvency, a full and detailed discussion of the issue was best placed in the chapter on Default and Enforcement.

19. As to whether the administrator would act outside an insolvency proceeding in the interest of the secured creditor only or of all creditors, differing views were expressed. One view was that the administrator would act in the interest of the secured creditor since the appointment was a method of enforcement of the security

right. If that caused other creditors to be concerned, they could apply to the court to have the debtor declared insolvent. Another view was that, as the appointment was intended to preserve the value of the enterprise as a going concern and was very close to insolvency, the administrator would act in the interest of all creditors, in particular in the case of an administrator appointed by the debtor to reorganize the enterprise. It was stated that such a method of enforcement was very close to insolvency and raised also the issue of applicability of avoidance actions.

20. With regard to paragraph 28, the Working Group agreed that, while the last sentence was true of many States, additional language might be added to the effect that the discussion in the draft guide only concerned movables and did not prevent a State from allowing an enterprise mortgage to include immovables.

21. As to paragraph 32, it was stated that the pre-insolvency priority of an enterprise mortgage type of interest should not be changed and that, if such changes were made, they should be limited and transparent. In response, it was observed that recent legislation in some countries had limited such priority to a part of the total value of the enterprise so as to protect other creditors (see para. 17 above).

22. While support was expressed for paragraph 33, differing views were expressed as to whether it should be recast as a recommendation. In support of a recommendation along the lines of paragraph 33, it was stated that an all-asset security was a useful tool in a modern secured transactions system. In opposition to such a recommendation, it was observed that an all-asset security created the risks of over-collateralization and creditor monopoly.

## **B. Fixtures (paras. 34-35)**

23. While it was agreed that paragraphs 34 and 35 addressed an important matter, a number of concerns were expressed. One concern was that those paragraphs were misplaced in the chapter on Creation since they essentially addressed issues of publicity and priority. Another concern was that the discussion in those paragraphs was not complete since cases, where a movable was attached to another movable (accession) or where movables were processed, were not addressed. Yet another concern was that the ease of separation might not be appropriately judged on the basis of technical difficulty and cost.

24. In response to a question, it was noted that the relationship between a right in immovables and a right in related intangibles (e.g. rents), was addressed in the chapter on Priority. In response to another question, it was noted that special publicity for fixtures was addressed in the chapter on Publicity.

## **C. Proceeds (paras. 36-47)**

25. A number of suggestions were made with regard to paragraphs 36 to 47. One suggestion was that paragraph 41 should be supplemented with a reference to the reason for recognizing a right in civil or natural fruits (i.e. the expectation of the secured creditor to receive the income generated by the encumbered assets). Another suggestion was that paragraph 43 should clearly refer to the publicity system recommended in the draft guide. Yet another suggestion was that paragraph 46 should refer to the fact that, as the proceeds took the place of the encumbered assets, the proprietary nature of the right of the secured creditor in proceeds of the

encumbered assets was the natural result of the proprietary nature of the security right. Another suggestion was that, while allowing rights in proceeds was bound to result in conflicts between, for example, inventory and receivables financiers, it was important for practice to recognize such rights in proceeds.

26. As to the notes in paragraphs 44 and 45, it was agreed that they raised important issues that should be addressed in the draft guide. It was stated, however, that the issue of tracing in paragraph 45 was more important than the issue of timing in paragraph 44. It was also observed that assets would be proceeds or not, and that paragraph 44, combined with paragraph 72, might be misleading in that it unnecessarily added a third possibility, namely that assets would be “identifiable proceeds” (or “readily identifiable proceeds”). It was also pointed out that the principles adopted with respect to encumbered assets (e.g. concerning a generic description and the possibility of granting a security right in after-acquired assets) should also apply to proceeds, and that accordingly all that should be required was that the creditor proved that the proceeds were its encumbered assets. In addition, it was suggested the draft guide should discuss whether the right in proceeds was granted by law or by agreement. It was stated that it was a matter of convenience of the parties rather than a policy issue for the legislator, and that the draft guide should provide for both possibilities.

27. In response to a suggestion that the proceeds rules in the draft guide might follow the proceeds rules in the United Nations Convention on the Assignment of Receivables in International Trade (“the United Nations Assignment Convention”), it was observed that that approach might not be appropriate as the proceeds rules in the United Nations Assignment Convention were conflict-of-laws rules.

#### **D. Security agreement (paras. 48-60)**

28. It was stated that, in its generality, the statement in the second sentence in paragraph 48 that an additional act was required “in most legal systems” for the security right to be created might not be accurate. It was also observed that the statement in the second sentence of paragraph 49 might also not be accurate since a security right could be created automatically if the security agreement provided for that result to occur upon extension of credit at the discretion of the secured creditor. In response, it was said that paragraph 49 was intended to distinguish between a security agreement and a promise to grant security. However, after discussion, it was agreed that paragraph 49 was not necessary and could be deleted.

29. With regard to paragraph 50, it was suggested that, as the reference to the legal justification of a transaction was confusing, it should be deleted. That suggestion was objected to as the reference to the legal justification or basis for a transaction was important in some systems. It was also suggested that the last sentence of paragraph 50 should be revised since, in complex transactions or in transactions where the security was granted by a third party, the security agreement was a separate agreement. In addition, it was suggested that paragraph 50 should also refer to the fact that having a description of the encumbered assets in the security agreement minimized the risk of disputes over what was covered and the risk of manipulation after default.

30. As to paragraph 51, it was suggested that it should specify that both natural and legal persons could be parties to a security agreement (a matter that was said to

be implicit in the reference to “person” in the definition of “debtor” and “secured creditor” in part B of chapter I). It was also suggested that the draft guide should address the question whether enterprise mortgages or similar types of security rights could be granted by natural persons. In that connection, reference was made to the EBRD Model Law on Secured Transactions that allowed enterprise mortgages to be given only by enterprises.

31. With regard to paragraph 52, it was stated that the description of the encumbered assets should also be included in the minimum contents of the security agreement. It was also suggested that the date of the agreement should be added to the minimum contents.

32. As to paragraphs 54 to 58 and the issue of form, differing views were expressed. One view was that written form should not be required for the security agreement to be effective. It was stated that a form requirement would negatively affect a number of transactions that were concluded orally (e.g. sales with retention of title arrangements). It was also observed that, in some systems that had no form requirement even for real estate transactions, it would be very difficult to introduce such a requirement for movable assets.

33. However, the prevailing view was that a security agreement should be in writing. It was stated that written form provided certainty, which was said to be crucial where third parties were affected, and precluded post-default manipulation. It was also observed that transactions would not be negatively affected by requiring a simple writing that would not need to be signed by both parties and could include a data message (i.e. “information generated, sent, received or stored by electronic, optical or similar means, including, but not limited to, electronic data interchange (EDI), electronic mail, telegram, telex or telecopy”; see article 2 (a) of UNCITRAL Model Law on Electronic Commerce).

34. A suggestion was made that the recommendation could be that written form would be desirable but the matter would be left to the legislator or to the parties.

## **E. Proprietary requirements (paras. 61-70)**

35. With regard to paragraph 61, it was suggested that it should be specified that ownership included a limited proprietary right. The Working Group recalled its decision to defer discussion of the issue whether the asset or title to it was the object of the security right until it had an opportunity to consider paragraph 61 (see A/CN.9/532, para. 100). While the Working Group recognized that there were two theories on that issue, it agreed that paragraph 61 did not need to be revised. As to paragraph 62, it was suggested that, in the absence of concrete examples, the problem that it addressed was difficult to understand.

36. With regard to paragraphs 66 to 70, it was stated that, as they addressed matters dealt with elsewhere in the draft guide (e.g. the chapters on Publicity and Priority), they might not be necessary. It was also observed that, if those paragraphs were intended to be descriptive of various approaches, they should not be cast as recommendations (as was implicit in paragraph 75).

## **F. Summary and recommendations (paras. 71-75)**

37. There was sufficient support in the Working Group for paragraph 71. With regard to the note after paragraph 71, it was suggested that exceptions to the recommendations in paragraph 71 should be formulated to address types of secured obligation (see A/CN.9/WG.VI/WP.6/Add.3, paras. 5 and 6), types of asset (see A/CN.9/WG.VI/WP.6/Add.3, paras. 17 and 18) or types of security (see A/CN.9/WG.VI/WP.6/Add.3, para. 27) that might be subject to special, national or international, regimes. Reference was made to the Inter-American Model Law on Secured Transactions that introduced exceptions to the notion of all-asset security. Reference was also made to conventions such as the Cape Town Convention on International Interests in Mobile Equipment, since in some countries a later domestic law could supersede a convention.

38. However, it was suggested that a distinction should be drawn between types of asset, obligation or security that were subject to special laws other than general secured transactions law (which should be excluded from the scope of the draft guide altogether) and types of asset, obligation or security that were subject to secured transactions laws but involved registration in special registries (which should be included in the scope of the draft guide but excluded from the type of registration foreseen in the draft guide).

39. With regard to paragraph 72, it was suggested that it should be revised to refer to “proceeds”, rather than “readily identifiable proceeds”. It was also suggested that it should be made clear that the notion of “proceeds” included whatever was received with respect to the encumbered assets. In addition, it was suggested that recommendations should be formulated with respect to the issues addressed in the note to paragraph 72.

40. As to paragraph 73, it was suggested that it should be revised to reflect the views expressed in favour and against written form. It was also suggested that reference should be made to the definition of data message in article 2 of the UNCITRAL Model Law on Electronic Commerce. In that connection, it was stated that there was no reason why the written form requirement could not be satisfied by a data message, including an electronic record, as long as it could be retrieved and read, and showed that the grantor intended to grant a security right. In response to a question, it was observed that it did not matter who was the originator of the data message.

41. Support was expressed for the idea that the security agreement should identify the parties and reasonably describe the encumbered assets and the secured obligations. While the view was expressed that a specific description of the encumbered assets should be required, the prevailing view was that a generic description should be sufficient.

42. There was sufficient support in the Working Group for the recommendation in paragraph 74. It was also agreed that the recommendation in paragraph 75 should be revised to provide that an agreement was sufficient for the creation of a non-possessory security right, while acts of publicity would be relevant to the effectiveness of a security right as against third parties.

43. It was suggested that a recommendation should also be prepared for security in all assets of a debtor (an enterprise mortgage or floating charge type of right). It was also suggested that a recommendation should also be made for fixtures and accessions.

44. After discussion, the Working Group requested the Secretariat to revise chapter IV taking into account the views expressed and the suggestions made.

## **Chapter IX. Insolvency (A/CN.9/WG.VI/WP.9/Add.6)**

45. In view of the fact that insolvency law experts from Working Group V (Insolvency Law) were present, the Working Group went on to consider Chapter IX on Insolvency.

### **A. Introduction (paras. 1-4)**

46. A couple of suggestions were made with regard to paragraph 1. One suggestion was that, as the issues briefly addressed in Chapter IX were addressed at some length in the draft guide on Insolvency Law, the penultimate sentence in paragraph 1, addressing the need to refer to the draft guide on Insolvency Law for details, should be strengthened. Another suggestion was that, in the second sentence, reference should be made to policies reflected in the draft guide on Insolvency Law, without giving arbitrary and possible misleading examples of such policies.

### **B. Security rights in insolvency proceedings (paras. 5-6)**

47. It was suggested that the examples given in the last sentence of paragraph 6 should be deleted, since they might inadvertently give the impression that expedited reorganization proceedings dealt only with certain types of debt.

### **C. The inclusion of encumbered assets in the insolvency estate (paras. 7-19)**

48. The Working Group agreed that encumbered assets should be part of the estate. As to whether assets subject to a retention or transfer of title should be part of the estate, differing views were expressed.

49. One view was that such assets should be treated in the same way as encumbered assets. It was stated that giving the seller with a retention of title special and superior rights, unrelated to price and quality, would distort competition with other extenders of credit and thus have a negative impact on the price of goods and services, as well as to the availability and the cost of credit. In addition, it was observed that, even if the matter was to be dealt with as one relating to the continuation or rejection of the sales contract by the insolvency representative, the assets would not be turned over to the seller before the expiry of the 30- or 60-day period within which the insolvency representative would have to make a decision. Moreover, it was said that, in the case of reorganization, or in the case of liquidation of a business as a going concern, assets subject to a retention of title would be treated in the same way as all other assets necessary for the success of the reorganization or of the liquidation of a business as a going concern. Moreover, it was pointed out that the draft guide should make clear recommendations aimed at assisting countries without modern secured transactions in obtaining the benefit of increased access to low-cost credit rather than focusing on historical developments

in certain countries which, in any case, with regard to retention of title, differed widely.

50. Another view was that assets subject to retention or transfer of title should not be part of the estate. It was stated that the seller or transferee of assets were not creditors and assets sold or transferred in a legitimate way by the debtor to another person should not be subject to the estate. Yet another view was that only assets subject to retention of title should not be part of the estate, since transfers of title for security purposes were assimilated to normal security rights in the case of insolvency, even in countries that otherwise treated them as title devices. It was observed that such a privileged treatment given to supplier credit resulted in cost-efficiencies, since supplier credit was readily available at lower cost than bank credit, and counter-balanced the dominant position of the financing institutions in the credit markets. In addition, it was said that preference given to supplier-credit was a policy decision dictated by the need to support supply markets of goods and services. For those reasons, it was suggested that retention of title should be given priority as of the time it was granted (even if it was subject to registration; “super-priority”).

51. Yet another view was that the legal characterization of retention or transfer of title as security or not did not matter in insolvency as long as the assets subject to a retention or transfer of title or the debtor’s rights in relation to those assets were part of the estate. It was stated that the real issue was not the legal characterization but the economic consequences of treating retention of title for purposes of publicity and insolvency as a security device or not. In response, it was stated, however, that, legal characterization did matter since, if retention of title was assimilated to a security right and assets subject to retention of title were part of the estate, the insolvency representative could keep them without having to pay the outstanding price even though it had not rejected the contract. Only if retention of title was treated as a title device, assets subject to it would be outside the estate, and, as a result, the insolvency representative would be obliged to pay the outstanding balance of the price, before any payment to other secured creditors, in order to keep the assets in the estate.

52. The Working Group noted that a broad definition of “assets” was to be considered by Working Group V (Insolvency Law) (“property, rights and interests of the debtor, including rights and interests in property whether or not in the possession of the debtor, tangible or intangible, movable or immovable, including the debtor’s interests in assets subject to a security right or in third party-owned assets”). As a result, the following suggestions were made: the second sentence of paragraph 10 should be revised to reflect that all assets or rights of the debtor in relation to the assets were part of the estate, irrespective of the legal characterization of the underlying transaction; paragraph 11 should provide that transfers of assets by the debtor to the creditor would be subject to avoidance actions; paragraph 12 should provide that, if retention of title was assimilated to a security right, assets subject to retention of title arrangements would be part of the estate; paragraph 17 should provide that proceeds of encumbered assets would be part of the estate, subject to the security right, and that after-acquired assets would not be subject to the security right, unless they constituted proceeds of the encumbered assets.

53. In response to a question, it was noted that the proposed definition of “assets” did not constitute a change in the position taken in the draft guide on Insolvency



Law that, while third-party assets were not part of the insolvency estate, the debtor's interests in such assets were. The Working Group agreed that any redrafting of that section should be consistent with that policy decision.

54. In the discussion, a number of suggestions were made. One suggestion was that paragraph 7 should be revised to clearly provide that encumbered assets were part of the estate. It was also suggested that, in paragraph 7, examples should be given of situations in which assets of the third-party grantor could be in the possession of the debtor. Another suggestion was that, in paragraph 10, reference should be made not only to contractual but also to proprietary rights of the debtor in relation to the encumbered assets. Yet another suggestion was that in paragraph 11, the reference to "payment or other performance by the debtor" should be substituted for the reference to "price". Yet another suggestion was that paragraphs 14 and 15 should be supplemented with reasons justifying one or the other approach to the question about the surplus remaining after payment of the seller. Yet another suggestion was that the issue of who bears the risk of any shortfalls should also be discussed. Yet another suggestion was that paragraph 16 should be revised to provide that the value of the assets might need to be determined at various times in an insolvency proceeding, depending on the purpose of the evaluation (e.g. the secured creditor may seek relief from stay because the value of the security right exceeds the value of the asset).

55. After discussion, the Secretariat was requested to revise the section so as to address the views expressed and the suggestions made, aligning the section with the relevant sections of the draft guide on Insolvency Law.

#### **D. Limitations on the enforcement of security rights (paras. 20-27)**

56. The Working Group noted that, under the approach taken in the draft guide on Insolvency Law, the stay applied to all creditors, including secured creditors, and to owners of assets in which the debtor had an interest (e.g. retention of title holders). It was suggested that the third sentence of paragraph 22 should be revised to reflect that approach. It was also suggested that paragraph 27 should be aligned with the relevant recommendations of the draft guide on Insolvency Law (35)(b), relief from measures applicable on commencement, and (43), burdensome assets). In addition, it was observed that the delay in disposing of the assets by the insolvency administrator, mentioned in the second sentence of paragraph 25, was not among the reasons for relief from the stay set forth in recommendation (35)(b).

#### **E. Participation of secured creditors in insolvency proceedings (paras. 28-29)**

57. It was noted that the draft guide on Insolvency Law provided secured creditors with a right to fully participate in the insolvency proceedings. It was, therefore, suggested that, once that point was made, a cross reference could be included to the relevant section of the draft guide on Insolvency Law and the remaining text in paragraphs 28 and 29 could be deleted. While it was agreed that paragraph 29, reflecting notions that were generally accepted in current law, could be deleted, a question was raised as to the appropriateness of deleting paragraph 28 which introduced some ideas about participation of secured creditors in creditor

committees. In response, it was observed that, under the current approach followed in the draft guide on Insolvency Law, secured creditors would participate in secured creditor committees. It was pointed out that some reference to that matter could usefully be made in the new text that would replace paragraphs 28 and 29.

58. It was also suggested that the general statement about full participation of secured creditors in insolvency proceedings could be usefully supplemented by the statement that whether the secured creditor would participate as secured or unsecured creditor would depend on whether the secured obligation exceeded the value of the encumbered assets or not.

#### **F. The effectiveness of security rights and avoidance actions (paras. 30-32)**

59. The Working Group noted that avoidance of secured transactions in insolvency proceedings was discussed at length in the draft guide on Insolvency Law and agreed that paragraphs 30 to 32 should include a cross reference to and be consistent with the relevant section of that draft guide.

60. It was stated that the failure of a creditor to take the steps necessary to make a security right effective against third parties (described in the draft guide on Insolvency Law with the term “perfection”) was a ground for avoiding the secured transaction that should be addressed in the draft guide. It was noted that the draft guide addressed that matter in the chapters on Publicity and Priority.

61. The concern was expressed that the reference to “transfer” in paragraph 31 might not be sufficiently clear. In order to address that concern, the suggestion was made that reference could be made to notions used in the draft guide on Insolvency Law, such as creation or “perfection” of a security right in the suspect period. An alternative suggestion was to simply refer to “secured transactions”.

62. In the discussion, the suggestion was made that the section might address situations where a security right was granted by a company to another company in the same group. The suggestion was also made that paragraphs 30 to 32 should emphasize the need for short suspect and prescription periods, in particular with respect to transactions that were not fraudulent but just took place in the suspect period. Noting the first matter was dealt with by law other than secured transaction law and that the second matter was addressed in the draft guide on Insolvency Law, the Working Group decided not to address them.

#### **G. The relative priority of security rights (paras. 33-35)**

63. The Working Group agreed that, as stated both in paragraph 33 and in the draft guide on Insolvency Law, insolvency law should respect the pre-commencement priority of security rights. It was also agreed that any exceptions to that principle should be limited and, if made, expressed in a transparent and predictable way.

64. As to the examples set forth in paragraph 34, differing views were expressed. One view was that the examples should be deleted, so as not to provide any possible endorsement of such privileges (or “super priorities”). The economic effect of such privileges, it was stated, was to reduce the value available to secured creditors, thus

reducing the amount of credit available and driving up the costs. It was also observed that such a result was inconsistent with the key objectives of the draft guide.

65. Another view was, while such exceptions would not be recommended, the examples should be retained. It was observed that such an approach could enhance the usefulness and the credibility of the draft guide, which could be undermined by the lack of any discussion on an issue widely discussed in expert circles and addressed even in modern insolvency legislation. The Working Group noted with interest that a similar discussion to that in paragraph 34 was contained in the draft guide on Insolvency Law (see A/CN.9/WG.V/WP.63/Add.14, para. 424). In response, it was observed that, if the examples were to be retained, the text should include a clear statement about the potentially deleterious effects of such exceptions on the availability and the cost of credit.

66. Yet another view was that the draft guide should discuss the issue, setting the advantages and disadvantages of such privileges and leaving the decision to the legislator. It was observed that by presenting the policy question, the potential approaches and their relative advantages and disadvantages, the draft guide would be more effective in achieving its objective of providing guidance to legislators and enhancing the availability of low-cost credit. In addition, it was stated that, in some countries, such exceptions might be necessary as a result of even constitutional law provisions. It was also observed that, in countries that did not allow security to be granted over the entirety of a debtor's assets, limiting the value of the security to a percentage of the debtor's assets or preserving a percentage of the debtor's assets for unsecured creditors in the case of insolvency ("ring-fencing"), was possibly the only way for those countries to accept an all-asset type of security. In that connection, in view of the Working Group's discussion of enterprise mortgages and floating charges (see paras. 16-22 above), the suggestion was made that ring-fencing could be limited to all-asset types of security (and, possibly, to involuntary creditors as a result of tort actions).

67. In the discussion, the suggestion was made that paragraph 33 could be usefully supplemented by a reference to the need for insolvency law to honour pre-commencement subordination agreements. Noting that the matter was being considered by Working Group V (Insolvency Law), the Working Group agreed that efforts of the two Working Groups on that matter should be coordinated.

68. A number of drafting suggestions were also made, including: to replace the word "amount" in the penultimate sentence of paragraph 33 with the words, "scope" or "extent"; to add, in the last sentence, the words "such as labour or tax law" after the word "forth" and to delete the rest of the current text; to add a fourth sentence to paragraph 33 to refer to the economic impact of privileges on the availability and the cost of credit; to replace in paragraph 35 the word "because" with the word "to the extent".

69. After discussion, the Secretariat was requested to revise the section taking into account the different views expressed, and providing some balance to the current text, bearing in mind the objective of the draft guide to enhance the availability of secured credit, in particular, in developing countries.

## **H. Post-commencement financing (paras. 36-41)**

70. It was suggested that the word “solvent” might be deleted from the penultimate sentence of paragraph 41 in order to avoid an implication that it was inappropriate to extend credit to an insolvent debtor. Otherwise, the Working Group expressed satisfaction with the current drafting of the section.

## **I. Reorganization proceedings (paras. 42-47)**

71. A number of suggestions were made. One suggestion was that paragraph 44 should be deleted as it was inconsistent with the position taken by Working Group V (Insolvency Law) that secured creditors should participate in insolvency proceedings. Another suggestion was that the first sentence of paragraph 45 should be revised to refer to what happened if a secured creditor did not consent to a reorganization plan. Yet another suggestion was that, at the end of paragraph 46, language along the following lines should be added: “It may also be appropriate to provide the secured creditor with terms relating to the secured obligation that are consistent with those prevailing in the open market.”

## **J. Expedited reorganization proceedings (paras. 48-51)**

72. The Working Group agreed that the section should be aligned with the relevant discussion in the draft guide on Insolvency Law, one of the main features of which was that expedited reorganization proceedings were formal proceedings.

## **K. Summary and recommendations (paras. 52-59)**

73. It was agreed that paragraph 52 should be revised to clarify that: where retention of title was treated as a security right, assets subject to it were part of the insolvency estate; where retention of title was treated as a non-security device, assets subject to it were not part of the estate; and that assets relating to a transfer of title for security purposes were part of the estate, since such a transfer was assimilated to a security device. It was agreed that the status of retention of title in and outside insolvency had not been settled and remained open. In addition, it was agreed that, consistent with the draft guide on Insolvency Law, paragraph 54 should refer to the principle of “full” participation of secured creditors in insolvency proceedings. Moreover, it was agreed that, to provide necessary flexibility to parties seeking to formulate a reorganization plan, the phrase “unless the secured creditor otherwise agrees” should be added at the beginning of the second sentence of paragraph 58. It was also agreed that some amendment of paragraph 59 was necessary given the suggestions to revise paragraphs 48 to 51, and that a redrafted provision might be based on the language of paragraph 51 slightly amended. The Working Group expressed satisfaction with the current drafting of paragraphs 53 and 55 to 57.

74. At the close of its deliberations on chapter IX, the Working Group requested the Secretariat to prepare a revised version of the chapter, taking into account the views expressed and the suggestions made.

## **L. Relationship between the two guides**

75. The Working Group went on to consider the issue of the relationship between the draft guide and the draft guide on Insolvency Law. At the outset, it was agreed that the two guides should be consistent with each other. As to how that objective could be best achieved, differing views were expressed.

76. One view was that the chapter on Insolvency should provide a full discussion of the issues, replete of information on the possible approaches and their relative advantages and disadvantages, with examples, where necessary to illustrate a point, and firm recommendations even where those issues were addressed at length in the draft guide on Insolvency Law. It was stated that the chapter was a unique text, perhaps the most important chapter in the draft guide, and might be read in isolation from the draft guide on Insolvency Law. It was also observed that the chapter should be capable of standing alone to provide effective guidance in particular in those countries where the authorities responsible for reform in secured transactions law and in insolvency law were not the same. It was also observed that the draft guide was the place for the importance of the availability of secured credit to be emphasized, which was a point that the draft guide on Insolvency Law could not make with the same emphasis.

77. Another view was that the chapter on Insolvency should be kept as short as possible. It was observed that clarity was not affected by a shorter text, as long as appropriate reference was made to relevant parts of the draft guide on Insolvency Law. It was also pointed out that a shorter text was in the interest of avoiding divergences or, at best, repetitious advice in the two guides. In addition, it was said that expanding the chapter on Insolvency, in particular on issues discussed at length in the draft guide on Insolvency Law, might inadvertently result in overemphasizing the position of the secured creditors and detract from the overall objective for a balanced and workable approach that would offer comprehensive and consistent advice to States.

78. After discussion, it was agreed that the chapter on Insolvency could contain a full discussion of the relevant issues as long as that discussion was consistent with the discussion in the draft guide on Insolvency Law. It was also agreed that the chapter should emphasize the importance of secured credit and that the guides should be read together.

## **M. Coordination with Working Group V (Insolvency Law)**

79. The Working Group next turned to the issue of coordination with Working Group V (Insolvency Law). It was noted that Working Group V was expected to complete its work at its next session (New York, 22-26 March 2004) and to submit the draft guide on Insolvency Law to the Commission at its thirty-seventh session (New York, 14 June-2 July 2004) (see para.121 below).

80. In view of the urgency and the importance of coordination, the Working Group agreed that another joint session of the two working groups should be held. In addition, it was agreed that that joint session could be held in conjunction with the Working Group's fifth session (New York, 29 March-2 April 2004). Moreover, it was agreed that the purpose of such a joint session, which might take one and a half days (29-30 March 2004), would be to discuss any outstanding issues and, to the extent necessary, to finetune the text on the intersection of the two guides. In that

connection, it was noted that the importance of internal coordination of delegations in the two working groups could not be overemphasized.

81. As to the issues that remained pending and should be discussed, a number of suggestions were made, including: the treatment of retention of title (and, perhaps, of transfer of title, conditional sales and financial leases) and subordination agreements in insolvency; the question of super-priorities in particular with respect to security in all of a debtor's assets; the protection of the value of the security right, including the time and the manner of determining the economic value of the security right; the length of the suspect period for avoiding preferential transfer; and the length of the period by which an insolvency representative might commence avoidance actions in relation to a secured transaction.

82. As to the intersection of the two guides, it was noted that security-related issues were discussed in various places of the draft guide on Insolvency Law, including in: chapter II. Treatment of assets upon commencement (A. 2 (b), Encumbered assets; A. 2 (c), Third party owned assets; B. 3 (c), Scope of application of the stay—secured creditors; B. 6, Duration of application of the stay; B. 8, Protection of secured creditors; B. 9, Limitations on disposal of assets by the debtor; C. 2, Use or disposal of secured assets; C. 3, Third party owned assets; C. 4, Treatment of cash proceeds; D. 3 (a), (b), Priority and security for post-commencement finance; E. Treatment of contracts; and F. 3 (d), Avoidance of Security interests); chapter III. Debtor, insolvency representative and creditors (C. 2 (f), Secured creditors—participation in insolvency proceedings); chapter IV. Reorganization plan (A. 5 (b), Approval by secured creditors); chapter V. Management of proceedings (A. 2 (a), Creditors required to submit claims); chapter VI. Priorities (C. 1 (a), Security interests).

83. After discussion, the Secretariat was requested to prepare a list of issues to be discussed at the joint session, taking into account the suggestions made.

## **Chapter I. Introduction (A/CN.9/WG.VI/WP.6/Add.1)**

### **A. Purpose and scope (paras. 1-13)**

84. The Working Group considered the scope of the draft guide. It was agreed that, in principle, all types of assets were capable of being the object of a security right and could be included in the scope of the draft guide, unless they were specifically excluded. Examples of clear exclusions mentioned were: securities; ships and aircraft (at least, for registration and priority purposes); and assets covered by certain conventions. As a practical matter, however, it was agreed that the focus of the draft guide should be on core commercial assets, such as goods, including inventory and equipment, and trade receivables, while the viability of including in the draft guide assets, such as promissory notes, checks, letters of credit, deposit accounts and intellectual and industrial property could be examined.

85. In particular, as to intellectual and industrial property rights, interest was expressed in view of their economic importance and the fact that they were part of transactions in which security was taken over the entirety of a debtor's assets and where security was taken over equipment. At the same time, a note of caution was struck in view of the complexity of the matters involved. In any case, it was agreed that any efforts in that field of law should be undertaken in coordination with

relevant organizations, such as the World Intellectual Property Organization (WIPO).

86. In the discussion, interest was expressed in a regime that would facilitate the cross-border recognition of security rights. It was stated that the so-called “home-country rule” could be examined with a view to determining whether a solution could be found to the problem of non-recognition of security rights once the encumbered assets passed national borders. While that statement was met with interest, it was observed that financing transactions presented many complexities that could not be resolved by way of a pure conflict-of-law approach. It was also said that the question of cross-border recognition was dealt with in chapter X (Conflict of Laws), which also included more general choice of law rules.

87. As to the formulation of various paragraphs, a number of suggestions were made. One suggestion was that, in paragraph 8, the reference to immovables should be deleted to avoid an implication that the regime envisaged in the draft guide was intended to interfere with real estate law and real estate registries. Reference was made to the Working Group’s earlier discussion (see para. 20 above) that the draft guide only concerned movables, though it did not prevent a State from allowing an enterprise mortgage-type of right to include immovables. Another suggestion was that paragraph 11 should be placed in square brackets, deferring a full consideration of that text until the relevant issues had been fully resolved by the Working Group. Yet another suggestion was that in paragraph 13 reference should be made to the OHADA Uniform Act organizing securities.

## **B. Terminology (para. 14)**

### **Security right**

88. It was agreed that the square brackets around the word “fixtures” should be deleted. It was also agreed that no explicit reference was necessary to “accessions” since accessions were covered by the reference to “movable property”. It was also suggested that the reference to *in rem* rights could be substituted with more general wording referring to the *erga omnes* effects of a security right. In addition, it was suggested that the types of assets that could be the object of security could be limited to commercial assets or corporate assets. That suggestion was objected to in particular in view of the broad approach taken by the Working Group in relation to that matter (see para. 37 above).

### **Grantor**

89. It was agreed that reference to the grantor’s ownership or possession of the assets should be deleted (“its assets”). It was also agreed that the term “person” was sufficient to cover both physical and legal persons.

### **Tangibles**

90. It was suggested that the definition of “tangibles” was tautological and should be revised.

### **Fixtures**

91. It was suggested that reference should be made to the immovable property “to which the fixtures were attached”.

**Proceeds**

92. It was agreed that the definition could be revised along the following lines: “Proceeds means whatever is received in respect of encumbered assets. ‘Proceeds’ include fruits of the encumbered assets”. It was stated that, in that way, involuntary proceeds (e.g. insurance proceeds) would be covered and the same rules could apply to both proceeds and fruits. The possibility of having separate definitions for fruits and proceeds was also mentioned. It was also stated that the difference with the definition of “proceeds” in the United Nations Assignment Convention was due to the different context and the fact that the Convention covered also outright transfers.

**Priority**

93. It was explained that the definition of priority was different from the definition of the term in the United Nations Assignment Convention since the context in the Convention was different and the definition served a different purpose (to refer to the applicable law a number of priority-related issues).

**Possessory security right**

94. The suggestion to refer to “control” as a way to exercise possession in intangible assets was objected to. It was stated that the reference to possession by way of an agent was sufficient. It was also stated that, before any changes were made, the use and the meaning of the terms “possession” and “control” in the text of the draft guide should be verified.

**Insolvency proceedings/insolvency representative**

95. The Secretariat was requested to align the definitions of the terms “insolvency proceedings” and “insolvency administrator” with the relevant definitions in the draft guide on Insolvency Law.

**New definitions**

96. It was suggested that definitions should be added for the terms “purchase money”, “security right”, “account debtor” and “buyer in the ordinary course of business”. Due to the lack of time there was no discussion on that suggestion.

**C. Examples of financing practices to be covered in the guide (paras. 15-26)**

97. There was general agreement in the Working Group that the examples used were both well chosen and structured. It was also agreed that the limit in number and detail aided comprehension, and for that reason, there was a general reluctance to make major alterations to the current text.

98. With regard to paragraphs 17 and 19, it was suggested that reference should be made to purchase-money financing, which should be defined, rather than to retention of title. It was also suggested that retention of title should be assimilated to a security right. That suggestion was objected to (see para. 107 below). It was



stated that, in many countries, retention of title was not treated as a security device and thus, at least for those countries, retention of title was not covered by the current definition of “security right” contained in the draft guide. In that connection, it was suggested that retention of title should be either excluded from the scope of the draft guide altogether or included and subjected to special rules.

99. As to paragraph 20, a number of suggestions were made, including: to refer to financial lease; to refer to an option (not a requirement) for the lessee to buy; to deposit accounts along the following lines: “Agrico maintains a bank account with Lender A, whose loan enabled Agrico to pay the purchase price for the wheels. Lender A takes a security right against the bank account to guarantee repayment of the loan.” As to paragraph 23, it was suggested that it should be revised to refer to inventory and receivables that were acceptable as security.

## **Chapter II. Key objectives**

### **(A/CN.9/WG.VI/WP.6/Add.1, paras. 27-36)**

100. With regard to paragraph 27, it was stated that it reflected the overall purpose of the project and should thus be further elaborated to refer to the economic impact of secured transactions law. It was stated that the draft guide should not be a comparative law treatise but should rather include analysis and recommendations that could assist in obtaining access to credit markets especially in developing countries. While it was agreed that the economic impact of one or the other approach taken in the draft guide was a major consideration, it was stated that the economic results of any law were difficult to measure, and, in any case, depended also on the relevant infrastructure, including the judicial system and enforcement mechanisms, a point that was said to be well made in paragraph 2 of the chapter.

101. As to paragraph 28, it was suggested that reference should be made to future and contingent obligations (see A/CN.9/WG.VI/WP.6/Add.3, para. 9). As to paragraph 30, it was suggested that it should be revised to clarify that mandatory law provisions should be kept to a minimum so as to leave room for party autonomy. It was also suggested that reference should be made to the fact that the draft guide would not override consumer-protection law rather than that it would include consumer-protection provisions.

102. As to the last sentence of paragraph 35, it was observed that it should be revised to clarify that a security right should be allowed to fulfil its main function of assisting the secured creditor in recovering at least part of its claim in insolvency proceedings. While there was support for that suggestion, it was pointed out that the point should be made in a manner that was consistent with the work of Working Group V (Insolvency Law) and took into account considerations relating, in particular, to reorganization.

## **Chapter VII. Priority (A/CN.9/WG.VI/WP.9/Add.3)**

### **A. Introduction (paras. 1-5)**

103. It was stated that the introduction sufficiently emphasized the economic importance of the concept of priority but needed also to further explain the

recommended rules and to link them with the key objectives of the draft guide. It was also observed that the concept of priority should be defined in a practical way to facilitate competition among, and avoid discrimination against credit providers.

104. In addition, it was suggested that, in paragraphs 2 and 4, reference should be made to the recommendation in paragraph 89 with regard to the modification of priority by agreement. As a matter of drafting, it was suggested that the introduction should assist the reader to navigate through the chapter by including cross references to subsequent sections.

#### **B. Priority rules (paras. 6-14)**

105. With regard to the discussion about grace periods in paragraph 10, it was suggested that it should be revised to clarify that they should be considered only if filing could not take place in advance of the conclusion of the security agreement or the disbursement of funds. It was also suggested that the last example in paragraph 10 should be deleted, because, in a first-to-file rule, the time of creation was irrelevant and the example prejudged the issue of the time of effectiveness of filing addressed in chapter V (Publicity and filing).

106. As to paragraph 12, it was suggested that, until the Working Group had been able to agree on the basic rules applicable to security rights in core commercial assets, reference to the notion of control out of context was an unnecessary complication and should thus be deleted. That suggestion was objected to. As to paragraph 13, it was suggested that the reference to the notion of “perfection” should be replaced by a reference to publicity. It was also suggested that the paragraph needed to explain why possession trumped filing.

#### **C. Alternative priority rules (paras. 15-17)**

107. As to paragraph 17, one view was that it contained an unbalanced discussion of retention of title. In support of that view, it was stated that: the fact that there was no single model of retention of title did not mean that it was an ineffective device; retention of title did not inhibit competition and was not more, but rather less, costly than other similar transactions; it was said that it was not easy for developing countries in particular to establish a registration system; and that paragraph 17 was based on the unrealistic assumption of closed national markets, and ignored the difficulties of filing in the seller’s country (problem of transparency) or in the buyer’s country (cost for the seller). Another view, expressed briefly due to the lack of sufficient time, was that the discussion in paragraph 17 was appropriately balanced. It was stated that transparency, predictability and certainty were the criteria against which the various approaches should be tested.

#### **D. Unsecured creditors (paras. 19-20)**

108. As to paragraph 20, it was suggested that it should include a reference to the issue of setting aside a percentage of the assets of the debtor for the satisfaction of debts owed to unsecured creditors. It was observed that the advantages and disadvantages of such an approach should also be discussed. In response, it was stated that that matter was addressed in chapter IX (Insolvency) and that, therefore,

a cross reference should be sufficient. It was also suggested that paragraphs 19 and 20 should be merged with the discussion of privileges and insolvency. In response, it was pointed out that paragraphs 19 and 20 were intended to make the basic point that secured creditors prevailed over unsecured creditors and that appropriate cross references were made to the logically subsequent discussion of privileges and insolvency. It was also observed that the priority of secured creditors was a key principle of the draft guide and paragraph 20 should be revised to state it in unequivocal terms.

#### **E. Purchase money security rights (paras. 21-29)**

109. The Working Group expressed satisfaction with the concept and the current description in paragraphs 21 to 29 of purchase money security rights. It was noted that purchase money security rights were security rights in all respects with the exception of any super priority with which they might be protected for policy reasons. It was also noted that such rights performed the same economic function as retention of title and conditional sales and the extent to which they should be protected was a matter of policy. It was stated that if such rights were to be given priority as of the time they were created (“super priority”), third parties should have an objective means of ascertaining their existence.

110. The Working Group agreed that such a right should be available not only to sellers but also to other creditors who provided purchase money finance (e.g. financing institutions). It was widely felt that, in countries with a retention of title system, the same result was achieved by an assignment of the seller’s claim to a financing institution, which resulted in the transfer of the retention of title to the financing institution.

111. In response to a question, it was stated that, in the rare situation where a financing institution and a supplier financed the purchase of the same assets by a buyer, the legislator would have to make a policy decision as to whether they should be paid proportionately or priority should be given to the supplier.

112. As to the notice discussed in paragraph 28, it was stated that it could be a renewable one-time notice and that, in order to avoid double financing, it should be required before delivery of the goods to the debtor.

113. In the discussion, the suggestion was made that the holder of a purchase money security right should not be liable for breach of a promise made by the debtor to a third party that no security right would be granted in the assets (“negative pledge agreement”). It was stated that that idea was reflected in articles 9 (1) and 18 (3) of the United Nations Assignment Convention.

114. After discussion, the Working Group agreed that generally, but in particular with respect to that matter, the focus should be on the economic results rather than on the techniques used to reach those results or any labels used. It was also agreed that paragraph 17 should be revised to reflect that understanding.

**F. Reclamation claims (paras. 30-33)**

115. It was noted that reclamation claims were mentioned in order to ensure that the priority rules, recommended in the draft Guide, would cover all possible conflict situations and thus enhance certainty as to the rights of competing claimants.

116. In response to a question, it was stated that reclamation claims were granted by law to a seller when the seller had not acquired a security right or retained title. It was also observed that their practical application was limited as they were subject to time limitations (e.g. 10 days after transfer) and were normally extinguished upon a further transfer of the relevant goods from the initial buyer to a subsequent buyer. As to the treatment of reclamation claims in insolvency proceedings, it was said that, in some systems, they could not be raised against the insolvency representative, while in other systems they could be raised in the same way security rights were. It was agreed that that was a matter for the draft Guide on Insolvency Law.

**G. Buyers of encumbered assets (paras. 34-41)**

117. The Secretariat was requested to align the definition of the term “inventory” with the discussion in paragraphs 34-41, which referred to the term “ordinary” rather than to “usual” course of business.

118. In response to a question, it was stated that only the buyer in the seller’s ordinary course of business should be protected and not also subsequent buyers (“remote purchasers”).

119. It was also suggested that paragraphs 34 to 41 should clarify that the buyer was protected if it acquired the encumbered assets in the seller’s ordinary course of business or if the secured creditor or the seller retaining title had authorized sales in the ordinary course of business. It was also suggested that those paragraphs should clarify that in both situations the secured creditor retained a security right in the proceeds from the sale of the encumbered assets.

120. After discussion, the Secretariat was requested to revise paragraphs 1 to 41 of Chapter VII taking into account the views expressed and the suggestions made.

**V. Future work**

121. The Working Group noted that, in view of the fact that the next session of Working Group V (Insolvency Law) (New York, 22 – 26 March 2004) would be the last session devoted to the draft guide on Insolvency Law, it would be advantageous to have the next session of Working Group VI (Security Interests) (New York, 29 March – 2 April 2004) and the joint session of the two working groups precede the session of the Working Group V. It was agreed that the Secretariat should, in consultation with the chairs of the two working groups and delegates, explore the feasibility of changing the dates of the sessions of Working Group V and VI, as well as of the joint session, which could be held on 26 March 2004.

**B. Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fourth session**

**(A/CN.9/WG.VI/WP.9 and Add.1-4, Add.6-8) [Original: English]**

**A/CN.9/WG.VI/WP.9**

**Background remarks**

1. At its thirty-third session in 2000, the Commission considered a report of the Secretary-General on possible future work in the area of secured credit law (A/CN.9/475). At that session, the Commission agreed that security interests was an important subject and had been brought to the attention of the Commission at the right time, in particular in view of the close link of security interests with the work of the Commission on insolvency law. It was widely felt that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade. It was also widely felt that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries, and in the share such parties had in the benefits of international trade. A note of caution was struck, however, in that regard to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States. It was also stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, would be advisable. Furthermore, in order to ensure the optimal benefits from law reform, including financial-crisis prevention, poverty reduction and facilitation of debt financing as an engine for economic growth, any effort on security interests would need to be coordinated with efforts on insolvency law.<sup>1</sup>

2. At its thirty-fourth session in 2001, the Commission considered a further report by the Secretariat (A/CN.9/496). At that session, the Commission agreed that work should be undertaken in view of the beneficial economic impact of a modern secured credit law. It was stated that experience had shown that deficiencies in that area could have major negative effects on a country's economic and financial system. It was also stated that an effective and predictable legal framework had both short- and long-term macroeconomic benefits. In the short term, namely, when countries faced crises in their financial sector, an effective and predictable legal framework was necessary, in particular in terms of enforcement of financial claims, to assist the banks and other financial institutions in controlling the deterioration of their claims through quick enforcement mechanisms and to facilitate corporate

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<sup>1</sup> Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17), para. 459.

restructuring by providing a vehicle that would create incentives for interim financing. In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential.<sup>2</sup>

3. While some concerns were expressed with respect to the feasibility of work in the field of secured credit law, the Commission noted that those concerns were not widely shared and went on to consider the scope of work.<sup>3</sup> It was widely felt that work should focus on security interests in goods involved in a commercial activity, including inventory. It was also agreed that securities should not be dealt with. As to intellectual property, it was stated that there was less need for work in that area, the issues were extremely complex and any efforts to address them should be coordinated with other organizations, such as the World Intellectual Property Organization (WIPO).<sup>4</sup> As to the form of work, the Commission considered that a model law might be too rigid and noted the suggestions made for a set of principles with a legislative guide that would include, where feasible, model legislative provisions.<sup>5</sup>

4. After discussion, the Commission decided to entrust a working group with the task of developing “an efficient legal regime for security rights in goods involved in a commercial activity, including inventory, to identify the issues to be addressed, such as the form of the instrument, the exact scope of the assets that can serve as collateral ...”.<sup>6</sup> Emphasizing the importance of the matter and the need to consult with representatives of the relevant industry and practice, the Commission recommended that a two- to three-day colloquium be held.<sup>7</sup>

5. At its first session (New York, 20-24 May 2002), Working Group VI (Security Interests) had before it a first, preliminary draft legislative guide on secured transactions, prepared by the Secretariat (A/CN.9/WG.VI/WP.2 and Add.1-12), a report on an UNCITRAL-CFA international colloquium, held in Vienna from 20 to 22 March 2002 (A/CN.9/WG.VI/WP.3), and comments by the European Bank for Reconstruction and Development (A/CN.9/WG.VI/WP.4). At that session, the Working Group considered chapters I to V and X (A/CN.9/WG.VI/WP.2 and Add.1-5 and 10), and requested the Secretariat to revise these chapters (A/CN.9/512, para. 12). At the same session, the Working Group agreed on the need to ensure, in cooperation with Working Group V (Insolvency Law), that issues relating to the treatment of security rights in insolvency proceedings would be addressed consistently with the conclusions of Working Group V on the intersection of the work of Working Group V and Working Group VI (see A/CN.9/512, para. 88 and A/CN.9/511, paras. 126-127).

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<sup>2</sup> Ibid., Fifty-sixth Session, Supplement No. 17 (A/56/17), para. 351.

<sup>3</sup> Ibid., para. 352-354.

<sup>4</sup> Ibid., paras. 354-356.

<sup>5</sup> Ibid., para. 357.

<sup>6</sup> Ibid., para. 358.

<sup>7</sup> Ibid., para. 359.

6. At its thirty-fifth session in 2002, the Commission had before it the report of Working Group VI (Security Interests) on the work of its first session (A/CN.9/512). The Commission expressed its appreciation to the Working Group for the progress made in its work. It was widely felt that, with that legislative guide, the Commission had a great opportunity to assist States in adopting modern secured transactions legislation, which was generally thought to be a necessary, albeit not sufficient in itself, condition for increasing access to low-cost credit, thus facilitating the cross-border movement of goods and services, economic development and ultimately friendly relations among nations.<sup>8</sup>

7. In addition, the feeling was widely shared that the timing of the Commission's initiative was most opportune both in view of the relevant legislative initiatives under way at the national and the international level and in view of the Commission's own initiative in the field of insolvency law. In that connection, the Commission noted with particular satisfaction the efforts undertaken by Working Group VI and Working Group V (Insolvency Law) towards coordinating their work on a subject of common interest such as the treatment of security interests in the case of insolvency proceedings. Strong support was expressed for such coordination, which was generally thought to be of crucial importance for providing States with comprehensive and consistent guidance with respect to the treatment of security interests in insolvency proceedings. The Commission endorsed a suggestion made to revise the insolvency chapter of the draft legislative guide on secured transactions in light of the core principles agreed by Working Groups V and VI (see A/CN.9/511, paras. 126-127 and A/CN.9/512, para. 88). The Commission stressed the need for continued coordination and requested the secretariat to consider organizing a joint session of the two Working Groups in December 2002.<sup>9</sup>

8. After discussion, the Commission confirmed the mandate given to the Working Group at its thirty-fourth session to develop an efficient legal regime for security interests in goods, including inventory. The Commission also confirmed that the mandate of the Working Group should be interpreted widely to ensure an appropriately flexible work product, which should take the form of a legislative guide.<sup>10</sup>

9. At its second session (Vienna, 17-20 December 2002), the Working Group considered chapters VI, VII and IX (A/CN.9/WG.VI/WP.2 and Add.6, 7 and 9) of the first preliminary draft guide on secured transactions, prepared by the Secretariat. At that session, the Working Group requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/531, para. 15). In conjunction with that session and in accordance with suggestions made at the first session of the Working Group (see A/CN.9/512, para. 65), an informal presentation of the registration systems of security rights in movable property of New Zealand and Norway was held. Immediately before that session, Working Groups V (Insolvency Law) and VI (Security Interests) held their first joint session (Vienna, 16-17 December 2002), during which the revised version of former chapter X (new chapter IX; A/CN.9/WG.VI/WP.6/Add.5) on insolvency was considered. At that session, the

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<sup>8</sup> Ibid., Fifty-seventh Session, Supplement No. 17 (A/57/17), para. 202.

<sup>9</sup> Ibid., para. 203.

<sup>10</sup> Ibid., para. 204.

Secretariat was requested to prepare a revised version of that chapter (see A/CN.9/535, para. 8).

10. At its third session (New York, 3-7 March 2003), the Working Group considered chapters VIII, XI and XII of the first preliminary draft guide on secured transactions and chapters II and III of the second version of the draft Guide (A/CN.9/WG.VI/WP.2/Add.8, A/CN.9/WG.VI/WP.2/Add.11, A/CN.9/WG.VI/WP.2/Add.12, A/CN.9/WG.VI/WP.6/Add.2 and A/CN.9/WG.VI/WP.6/Add.3) and requested the Secretariat to prepare revised versions (A/CN.9/532, para. 13). In conjunction with that session, an informal presentation was made of the recently completed secured transactions law in the Slovak Republic, which was supported by the World Bank and by the European Bank for Reconstruction and Development.

11. Addenda to this introductory document contain Chapters III, V, VI, VII, VIII, IX, X and XI of the revised draft Guide: Chapter III (Approaches to security): A/CN.9/WG.VI/WP.9/Add.1, Chapter V (Publicity and filing): A/CN.9/WG.VI/WP.9/Add.2, Chapter VI (Priority): A/CN.9/WG.VI/WP.9/Add.3, Chapter VII (Pre-default rights and obligations): A/CN.9/WG.VI/WP.9/Add. 4, Chapter VIII (Default and enforcement): A/CN.9/WG.VI/WP.9/Add.5, Chapter IX (Insolvency): A/CN.9/WG.VI/WP.9/Add.6, Chapter X (Conflict of laws): A/CN.9/WG.VI/WP.9/Add.7, and Chapter XI (Transition): A/CN.9/WG.VI/WP.9/Add.8.

12. The remaining Chapters are contained in: Chapters I (Introduction), II (Key objectives) (A/CN.9/WG.VI/WP.6/Add.1) and IV (Creation) (A/CN.9/WG.VI/WP.6/Add.3).



**Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fourth session**

ADDENDUM

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### **III. Basic approaches to security**

#### **A. General remarks**

##### **1. Introduction**

1. Over time, a broad variety of practices have been developed in different countries to secure a creditor's claims (usually for monetary payment) against its debtor. It is the purpose of this chapter to provide a broad survey of the various major approaches for affording the creditor effective means of security; the advantages and disadvantages of each approach to both the immediate parties

involved, i.e. creditor and debtor, and third parties; and the major policy options for legislators.

2. In general terms, it is possible to distinguish three major types of instruments that are used for the purposes of security. These are, first, instruments designed for and openly denominated as security (see section A.2); second, the recourse to title (ownership) for purposes of security combined with various types of contractual arrangements (see section A.3); and, third, an integrated comprehensive security (see section A.4).

## **2. Instruments traditionally designed for security**

### **a. Security rights in tangible movable property**

3. Traditionally, most countries distinguish between proprietary security rights in tangible movable property (“tangibles”; see section A.2.a) and those in intangible movable property (“intangibles”; see section A.2.b). In fact, the tangible nature of an asset gives rise to forms of security that are not available for intangibles (see paras. 8 and 25-26).

4. With respect to security rights in tangibles, most countries draw a distinction between possessory security (see section A.2.a.i) and non-possessory security (see section A.2.a.ii). Possessory is the security in which the encumbered assets are transferred into the possession of the creditor or a third party. Non-possessory is the security in which the grantor, who is usually the debtor but can also be a third party, granting the security retains possession.

#### **i. Possessory security**

##### **(a) Pledge**

5. By far the most common (and also ancient) form of possessory security in tangibles is the pledge. A pledge requires for its validity that the grantor effectively give up possession of the encumbered tangibles and that these be transferred either to the secured creditor or to a third party agreed upon by the parties (e.g. a warehouse). The actual holder may also be an agent or trustee who holds the security in the name, or at least for the account, of the creditor or a syndicate of creditors. The required dispossession of the grantor must not only occur at the creation of the security right but it must be maintained during the life of the pledge; return of the encumbered assets to the grantor usually extinguishes the pledge.

6. Dispossession need not always require physical removal of the encumbered assets from the grantor’s premises, provided that the grantor’s access to them is excluded in other ways. This can be achieved, for example, by handing over the keys to the warehouse in which the encumbered assets are stored to the secured creditor, provided that this excludes any unauthorized access by the grantor.

7. The grantor’s dispossession can also be effected by delivering the encumbered assets to, or by using assets that are already held by, a third party. Examples are merchandise or raw materials stored in a warehouse or a tank of a third party. An institutional (and more expensive) arrangement may be involving an independent “warehousing” company, which at the grantor’s business premises exercises control over the pledged assets as agent for the secured creditor. For this arrangement to be

valid, there cannot be any unauthorized access by the grantor to the warehouse in which the pledged assets are stored. In addition, the warehousing company's employees must not work for the grantor (if they are drawn from the grantor's workforce, because of their expertise, they may no longer work for the grantor).

8. In the case of assets of a special nature, such as documents and instruments (whether or not negotiable), that embody rights in tangible assets (e.g. bills of lading or warehouse receipts) or intangible rights (e.g. negotiable instruments, bonds or share certificates), dispossession is effected by transferring the documents or instruments to the secured creditor. However, in this context, the line between possessory and non-possessory security may not always be easy to draw.

9. In view of the grantor's dispossession, the possessory pledge presents three important advantages for the secured creditor. First, the grantor is unable to dispose of the pledged assets without the secured creditor's consent. Second, the creditor does not run the risk that the actual value of the encumbered assets will be reduced through the grantor neglecting upkeep and maintenance. Third, if enforcement becomes necessary, the secured creditor is saved the trouble, time, expense and risk of having to claim delivery of the encumbered assets from the grantor.

10. Possessory security also has advantages for third parties, especially the grantor's other creditors. The required dispossession of the grantor avoids any risk of creating a false impression of wealth and also minimizes the risk of fraud.

11. On the other hand, the possessory pledge has also major disadvantages. The greatest disadvantage for the grantor is the required dispossession, which precludes the grantor from using the encumbered assets. The disadvantage is acute in situations where possession of the encumbered assets is necessary for commercial grantors to generate the income from which to repay the loan (as is the case, for example, with raw materials, semi-finished goods, equipment and inventory).

12. For the secured creditor, the possessory pledge has the disadvantage that it has to store, preserve and maintain the encumbered assets, unless a third party assumes this task. Where secured creditors themselves are neither able nor willing to assume these tasks, entrusting third parties will involve additional costs that will be directly or indirectly borne by the grantor. Another disadvantage is the potential liability of the secured creditor in possession of encumbered assets (e.g. pledgee, holder of a warehouse warrant or a bill of lading) that might have caused damage. This is a particularly serious problem in the case of liability for contamination of the environment (see chapter IV, paras. ... and chapter VII, paras. ...).

13. However, where the parties are able to avoid the aforementioned disadvantages (see paras. 11-12), the possessory pledge can be utilized successfully. There are two major fields of application. First, where the encumbered assets are already held by or can easily be brought into the possession of a third party, especially a commercial keeper of other persons' assets. The second field of application is where instruments and documents, embodying tangible assets or intangible rights, can be easily kept by the secured creditor itself.

#### **(b) Right of retention of possession**

14. Statutory rights of retention are not discussed since, with few exceptions, statutory rights are outside the scope of this Guide (see A/CN.9/WG.VI/WP.6/Add.1,

para. 8). A right of retention created by agreement allows a party whose contractual partner is in breach of contract to withhold its own performance and, in particular, an asset which, under the terms of the contract, the withholding party is obliged to deliver to the party in breach. For example, a bank need not return documents of title, such as bills of lading, or negotiable instruments, such as bills of exchange or promissory notes, it holds for its customer or allow withdrawals from the customer's bank account, if the customer is in default on repayment of a credit and had agreed to grant the bank a right of retention. Where such a right of retention is reinforced by a valid power to sell the retained item, some legal systems regard such a reinforced right of retention as a pledge, although the method of its creation deviates from that of the pledge proper (see paras. 5-8). Alternatively, a reinforced right of retention may be regarded as having some of the effects of a pledge. The most important consequence of such an assimilation to a pledge is that the creditor in possession has a priority in the assets retained, unless they are subject to an earlier created and effective non-possessory security right.

## ii. Non-possessory security

15. As noted above (see para. 11), a possessory pledge of tangibles required for production or sale (such as equipment, raw materials, semi-finished goods and inventory) is economically impractical. These goods are necessary for the entrepreneurial activity of commercial grantors. Without access to, and the right and power of disposition over those assets, the grantor would not be able to earn the necessary income to repay the loan. This problem is particularly acute for the growing number of commercial grantors who do not own immovables that can be used as security.

16. To address this problem, laws, especially in the last fifty years, began providing for security in movable assets outside the narrow confines of the possessory pledge. While some countries introduced a new security right encompassing various arrangements serving security purposes, other countries created by legislation non-possessory pledge type of security rights with respect to certain specified assets. Most countries, however, continued the tradition of the nineteenth century (which disregarded an earlier, more liberal attitude) and insisted on the pledge as the only legitimate method of creating security in movable assets. In the twentieth century, legislators and courts in many of those countries have come to acknowledge the urgent economic need to provide for non-possessory security.

17. Individual countries attempted to find appropriate solutions according to particular local needs and in conformity with the general framework of their legal system. The result is a diverse range of solutions. An external indication of the existing diversity is the variety of names for the relevant institutions, sometimes differing even within a single country, such as: "fictive" dispossession of the grantor; non-possessory pledge; registered pledge; *nantissement*; warrant; *hypothèque*; "contractual privilege"; bill of sale; chattel mortgage; and trust. More relevant is the limited scope of application of the approaches taken. Only a few countries have enacted a general statute on non-possessory security (for a more comprehensive approach, see section A.4). Some countries have two sets of legislation on non-possessory security, one dealing with security for financing of industrial and artisan enterprises, the other with security for financing of farming and fishing enterprises.

In most countries, however, there is a variety of statutes on non-possessory security, covering only small economic sectors, such as the acquisition of cars or of machinery, or the production of films.

18. In some countries, there is even some reluctance to allow non-possessory security rights in inventory. This is sometimes based upon an alleged inconsistency between the creditor's security right and the grantor's right and power to sell which is indispensable for converting the inventory to cash with which to repay a secured loan. Another reason is that the disposition of inventory will often give rise to difficult conflicts between multiple transferees or multiple secured creditors. Yet another possible reason for not permitting non-possessory security rights in inventory may arise from a policy decision to reserve inventory for the satisfaction of the claims of the grantor's unsecured creditors (see A/CN.9/WG.VI/WP.9/Add.6, para. ...).

19. Varied as the legislation providing for non-possessory security might be, it shares one common feature, namely that some form of publicity of the security right is usually provided for. The purpose of publicity is to dispel the false impression of wealth which otherwise may be derived where the security right in assets held by the grantor is not apparent (for a detailed discussion of this matter, see A/CN.9/WG.VI/WP.9/Add.2, paras. ...). It is often argued that, in a modern credit economy, parties may assume that assets may be encumbered or may be subject to a retention of title. Such general assumptions, however, are bound to increase the cost of credit, even in cases where the person in possession is the owner and the assets are not encumbered (a risk that can be only partially avoided at the cost of an extensive and costly search). In addition, such assumptions fail to sufficiently protect the secured creditor or other third parties, since they do not reveal the name of the owner or previous secured creditor, the amount secured, or provide information as to the asset encumbered. Furthermore, in a system based on such general assumptions, there is no objective basis for a priority system to rank security rights in the same assets and thus grantors may not be able to use the full value of their assets to obtain credit.

20. There appears to be a need to bridge the gap between the general economic demand for non-possessory security and the often limited access to such security under current law. A major purpose of legal reform in the area of secured transactions is to develop suggestions for improvement in the field of non-possessory security and in the related field of security in intangibles (see section A.2.b).

21. While modern regimes demonstrate that difficulties can be overcome, experience has shown that legislation on non-possessory security is more complicated than the regulation of the traditional possessory pledge. This is due mainly to the following four key characteristics of non-possessory security rights. First, since the grantor retains possession, it has the power to dispose of or create a competing right in the encumbered assets, even against the secured creditor's will. This situation necessitates the introduction of rules concerning the effects and priority of such dispositions (see A/CN.9/WG.VI/WP.9/Add.3 on priority). Second, the secured creditor must ensure that the grantor in possession takes proper care of, duly insures and protects the encumbered assets to preserve their commercial value, matters which must all be addressed in the security agreement between the secured creditor and the debtor (see A/CN.9/WG.VI/WP.9/Add.4 on rights and obligations of

parties before default). Third, if enforcement of the security becomes necessary, the secured creditor will usually prefer to obtain the encumbered assets. However, if the grantor is not willing to part with those assets, judicial and extra-judicial proceedings may have to be instituted. Proper remedies and possibly an accelerated proceeding may have to be provided for (see A/CN.9/WG.VI/WP.9/Add.5 on default and enforcement). Fourth, the appearance of false wealth in the grantor which is created by “secret” security rights in assets held by the grantor may have to be counteracted by various forms of publicity. However, in modern credit economies, this problem is of declining importance to the extent that it is commonly known that possession does not imply that the person in possession is the owner or that the asset is unencumbered (this, however, has a cost; see para. 19) or to the extent that security rights are subject to publicity (see A/CN.9/WG.VI/WP.9/Add.2 on publicity).

22. In light of the generally recognized economic need for allowing non-possessory security and the basic differences between possessory and non-possessory security mentioned above (see para. 21), new legislation will be necessary in many countries.

23. In view of earlier legislative models (see paras. 16-19), legislators may be faced with three alternatives. One alternative may be to adopt integrated legislation for both possessory and non-possessory security rights (see section A.4). This is the well-considered approach of the Model Inter-American Law on Secured Transactions, adopted in February 2002. Another alternative may be to adopt integrated legislation for non-possessory security rights, leaving the regime on possessory rights to other domestic law. Yet another alternative may be to adopt special legislation allowing non-possessory security for credit to debtors in specific branches of business. The prevailing trend of modern legislation, both at the national and the international level, is towards an integrated approach at least as far as non-possessory security is concerned. A selective regulation of specific types of non-possessory security rights is likely to result in gaps, overlaps, inconsistencies and lack of transparency, as well as in discontent in those sectors of the industry that might be excluded. In addition, such selective regulation makes it more difficult to address conflicts of priority between possessory and non-possessory security rights.

#### **b. Security rights in intangible movable property**

24. Intangibles comprise a broad variety of rights (e.g. right to the payment of money or the performance of other contractual obligation, such as the delivery of oil under a production contract). They include some relatively new types of asset (e.g. uncertificated securities, held indirectly through an intermediary) and intellectual property rights (i.e. patents, trade marks and copyrights). In view of the dramatic increase in the economic importance of intangibles in recent years, there is a growing demand to use these rights as assets for security. Intangibles, such as receivables and intellectual property rights, are often part of inventory or equipment financing transactions, and form often the main value of the security in those intangibles. Furthermore, intangibles may be proceeds of inventory or equipment. This Guide does not deal with securities, since they raise a whole range of issues requiring special treatment and these issues are addressed in texts being prepared by the International Institute for the Unification of Private Law (UNIDROIT) and the Hague Conference on Private International Law. The Guide does, however, discuss

security in receivables, i.e. rights to claim payment of money, and rights to claim performance of non-monetary contractual obligations, as well as security in other types of intangibles as proceeds of tangibles or receivables.

25. By definition, intangibles are incapable of (physical) possession. Nevertheless, most codes of the so-called “civil law” countries have dealt with the creation of possessory pledges (see paras. 5-13) at least in monetary claims. Some codes have attempted to create the semblance of dispossession by requiring the grantor to transfer any writing or document relating to the pledged claim (such as the contract from which the claim was derived) to the creditor. However, such transfer does not suffice to constitute the pledge. Rather, the grantor’s “dispossession” is, in many countries, replaced (quite artificially) by requiring that a notice of the pledge be given to the grantor of the pledged claim.

26. In some countries, techniques have been developed that achieve ends comparable to those attained by the possession of tangibles. The most radical method is the full transfer of the encumbered right (or the encumbered share of it) to the secured creditor. However, this goes beyond creation of a security right and amounts to transfer of title (see section A.3.a). Under a more restrained approach, title to the encumbered rights is not affected but dispositions by the grantor that are not authorized by the secured creditor are blocked. In the case of a bank account, if the grantor (the creditor of the encumbered account) as holder of the account agrees that its account can be blocked in favour of the secured creditor, the latter has the equivalent of possession of a tangible movable. That is even more true if the bank itself is the secured creditor.

27. In modern terminology, such techniques of obtaining “possession” of intangible property are appropriately called “control”. The degree of control though may vary. In some cases, the control is absolute and any disposition by the grantor is prevented. In other cases, the grantor is allowed to make certain dispositions or dispositions up to a fixed maximum, as long as the secured creditor has access to the account. Control may be a condition for the validity of a security right (see A/CN.9/WG.VI/WP.6/Add.3, paras. 66 and 68) or priority (see A/CN.9/WG.VI/WP.9/Add.3, para. ...).

28. In the context of efforts to create comprehensive regimes for non-possessory security in tangibles (see section A.2.a), it is common for security in the most important types of intangibles (e.g. receivables) to be integrated into the same legal regime. This serves consistency since the sale of inventory results, as a rule, in receivables and it is often desirable to extend the security in inventory to the resulting proceeds. The publicity system used for security in tangibles can perform its salutary functions (for details, see A.CN.9/WG.VI/WP.9/Add.2 on publicity) for security in intangibles, such as receivables, as well. This may have the additional benefit of dispensing with notification of the debtor of encumbered receivables, which in certain security transactions involving a pool of assets that are not specifically identified may not be feasible. Even if such notification is feasible, it may not be desirable (e.g. for reasons of cost or confidentiality).

### **3. The use of title for security purposes**

29. In addition to instruments for security proper (see section A.2), practice and sometimes also legislation has in many countries developed an alternative approach

for non-possessory security rights in both tangible and intangible assets, namely title (or ownership) as security (*propriété sûreté*). Title as security can be created either by transfer of title to the creditor (see section A.3.a) or by retention of title by the creditor (see section A.3.b). Both transfer and retention of title enable the creditor to obtain non-possessory security (for the economic need for, and justification of, non-possessory security, see para. 15).

**a. Transfer of title to the creditor**

30. In the absence of a regime of non-possessory security rights, or to fill gaps or address impediments, courts and legislators in some countries have taken recourse to transfer of title of the assets to the secured creditor.

31. There are two features that make the security transfer of title attractive for creditors in certain jurisdictions. First, the formal and substantive requirements for transferring title in tangibles or intangibles to another person are often less onerous and, therefore, less costly than the requirements for creating a security right. Second, in the case of enforcement and in the debtor's insolvency, a creditor often has a better position as an owner than as a holder of a mere security right, especially where the owner's assets, although in the grantor's possession, do not belong to the insolvency estate whereas the grantor's assets, if merely encumbered by a security right for the creditor, are part of the estate. In other jurisdictions though the formal difference between title for security purposes and security rights with respect to the requirements for creation or enforcement has been levelled to the extent that title devices are subject to the same creation requirements as security rights proper. In yet other jurisdictions, security transfers are subject to the rules applicable to transfers of title while, in the case of enforcement and insolvency, they are treated as security devices.

32. The security transfer of title has been allowed by law in some countries and by court practice in other countries. In some countries, its creation is subject to the less demanding rules governing transfers of title and it has the effect of a full transfer of title. In other countries, its creation is subject to the more cumbersome rules governing security rights and it has only the effect of a secured transaction. In yet other countries, especially from the civil law world, such transfers of title are regarded as a circumvention of the ordinary regime of security instruments proper and are, therefore, held to be void. In countries with a comprehensive and workable regime for non-possessory security, transfer of title is available but is treated as a security device (see section 4). This means that its creation, publicity, priority and enforcement is subject to the same requirements applicable to security rights (in the case of insolvency, the assets are part of the estate; see A/CN.9/WG.VI/WP.9/Add.6, para. ...).

33. Legislators are faced with two policy options. One option is to admit security transfers of title with the (usually) reduced requirements and the greater effects of a full transfer (in the case of insolvency, the assets are not part of the estate; see A/CN.9/WG.VI/WP.9/Add.6, para. 11), thus avoiding the general regime for security rights. This option results in enhancing the secured creditor's position (although at the risk of increasing the liability of the creditor, see chapter IV, para. ...), while weakening the position of the grantor and the grantor's other creditors. This solution may make sense if the ordinary security regime for non-possessory security is underdeveloped.



34. The other option is to admit security transfers of title, but to limit either the requirements or the effects or both to those of a mere security right. Under the second option, a graduated reduction of the secured creditor's advantages and of the other parties' corresponding disadvantages is possible, especially if the requirements of a transfer or its effects or both are limited to those relating to a security right. This is the approach followed in countries with an integrated, comprehensive security regime, in which transfer of title is available but is subject to the same rules governing security rights (see section 4).

**b. Retention of title by the creditor**

35. The second method of using title as security occurs in the context of what is often called "purchase money financing" (see description and example in A/CN.9/WG.VI/WP.6/Add.1, paras. 16-19) and is effected by contractual retention of title (reservation of ownership). The seller or other lender of the money necessary to purchase tangible or even intangible assets may retain title until full payment of the purchase price (a simple retention of title arrangement).

36. In some countries, simple retention of title arrangements may be varied through various clauses, including: "all monies" or "current account" clauses, in which the seller retains title until all debts owing from the buyer have been discharged and not just those arising from the particular contract of sale; and proceeds and products clauses, in which title is extended to the proceeds and the products of the assets in which the seller retained title.

37. An alternative to a retention of title arrangement with the same economic result is achieved by combining a lease contract with an option to purchase for the lessee (for a nominal value), which may only be exercised after the lessee has paid most of the "purchase price" through rent instalments (see example in A/CN.9/WG.VI/WP.6/Add.1, para. 20). In some cases, where the lease covers the useful life of equipment, it is equivalent to a retention-of-title arrangement even without an option to buy. In the following paragraphs, at least with respect to leases that serve a security function, the term "seller" covers also the term "lessor", and the term "buyer" covers the term "lessee".

38. Economically, a retention of title arrangement provides a security right which is particularly well adapted to the needs of, and therefore is widely used by, sellers for securing purchase money credit. In many countries, this kind of credit, which is typically made available by suppliers, is widely used as an alternative to general bank financing and is given preferential status in view of the importance of small- and medium-size suppliers for the economy. In other countries, banks also provide on a more regular basis purchase money financing, for example, where the seller sells to a bank and the bank sells to buyer with a retention of title or where the buyer pays the seller in cash from a loan and transfers title to the bank as security for the loan. In those countries, this source of credit and its attendant specific security is given special attention.

39. Due to its origin as a term of a contract of sale or lease, many countries regard the retention of title arrangement as a mere quasi-security, and, therefore, not subject to the general rules on security, such as requirements of form, publicity or effects (principally priority). Further advantages are that it can be created in a cost-effective way since, in many countries, it is not subject to publicity. It is also well

suited to short-term financing and, in some countries, it gives rise to a proprietary right of the buyer. In countries that permit the creation of non-possessory rights only in certain types of assets, but not in inventory, retention of title is used for inventory financing. Another advantage is that the seller retaining title has, in many countries, a privileged status. This may be justified by the desire to support normally small- and medium-size suppliers and to promote purchase money financing by suppliers as an alternative to general bank credit. This privileged status may also be justified by the fact that the seller, by parting with the sold goods without having received payment, increases the grantor's pool of assets and requires protection.

40. At the same time, retention of title arrangements presents certain disadvantages. The position of the buyer and the buyer's creditors is weakened and, in the absence of publicity, third parties have to rely on the buyer's representations or take the time and cost so as to collect information from other sources. Another disadvantage is that it may prevent or, at least, impede the buyer from using the purchased assets for granting a second-ranking security to another creditor. Yet another disadvantage is that enforcement by the buyer's other creditors is impossible or difficult without the seller's consent. For these reasons, in some countries, retention of title arrangements are treated in the same way as security rights in every respect, while, in other countries, they are treated as security rights in some but not in all respects (e.g. they are subject to publicity but they are given a special priority status). In yet other countries, retention of title clauses are ineffective as against third parties in general or only if they relate to certain assets, especially inventory, on the theory that the seller's retention of title is incompatible with the seller granting to the buyer the right and power of disposition over the inventory.

41. Several policy options may be considered. One option is to preserve the special character of the retention of title arrangement as a title device. Under such an approach, retention of title would not be subject to any form requirement or publicity. It could secure claims other than the purchase price and be extended to products and proceeds of the asset in which it is created. The seller could, in the case of non-payment of the outstanding price, reclaim the assets from the buyer and dispose of them as the owner, without having to account to the buyer, except for any parts of the purchase price paid). Similarly, if the buyer becomes insolvent, the insolvency administrator would have to pay the outstanding purchase price to obtain title. If the insolvency administrator chooses not to pay, the seller could reclaim the assets as the owner or insist on payment of the outstanding purchase price (see A/CN.9/WG.VI/WP.9/Add.6, para. ...). Another, slightly different option would be to preserve the special character of the retention of title arrangement but to limit its effect to: securing only the purchase price of the respective asset to the exclusion of any other credit; and to restricting it to the purchased asset to the exclusion of proceeds or products.

42. Yet another option might be to integrate the retention of title arrangement into the ordinary system of security rights. In such a case, the creation, publicity, priority and enforcement, even in the buyer's insolvency (see A/CN.9/WG.VI/WP.9/Add.6, para. ...), of a retention of title arrangement would be subject to the same rules applicable to non-possessory security rights. Under such an approach, for the policy reasons mentioned above (see para. 38), it would be possible to grant the seller certain advantages (e.g. priority as of the time of the conclusion of the sales contract

in which the retention of title was contained or as of the time of delivery of the goods). Yet another option might be to place the retention of title fully on a par with any other non-possessory security (i.e. without granting the seller any privileges).

43. The first two options mentioned above (see para. 41) would preserve or create a special regime for retention of title outside a comprehensive system of non-possessory security rights. Retention of title arrangements would be implemented by special clauses in sales contracts and the seller would have a privileged position as against the buyer's creditors in the case of enforcement actions or the buyer's insolvency. In particular, the first option provides the seller (or other purchase money financier) with extensive privileges, a result that has consequential disadvantages for competing creditors of the buyer, especially in the case of enforcement and insolvency. In the absence of any publicity requirement, however, potential creditors would have to factor into their credit terms the risk of assets offered to them as security being subject to a retention of title arrangement, a result that could have a negative impact on the availability and the cost of credit.

44. The last two options mentioned above (see para. 42) are more in line with a comprehensive system of security rights. For the purposes of such secured transaction legislation, retention of title would be treated as a security device. For the purposes of other legislation (e.g. taxation law), retention of title could preserve its character as a title device. The first option, in particular, recognizes that the seller selling on credit deserves a certain privileged position (e.g. may have priority as of the time the relevant sales transaction is concluded), since it parts with the sold goods and sales on credit terms should be promoted for economic reasons (i.e. increased trade and economic growth). On the other hand, in the interest of competing creditors, the statutory privilege could be limited to the purchase price for the specific asset and to the sold goods as such. For the same reason, rights in proceeds or products of the purchased goods, or sums owing from the buyer other than those arising from the particular contract of sale with a retention of title clause, would not enjoy such a privilege and would be subject to the rules applicable to ordinary security rights (e.g. have priority as of the time the relevant transaction is registered).

45. Converting retention of title to a security right for the purpose of secured transactions legislation would enhance the position of the buyer since the buyer would be enabled to create a second-ranking (non-possessory) security right to secure a loan from another creditor. It could also improve the position of other creditors of the buyer in the case of enforcement with respect to the encumbered asset and in the case of the buyer's insolvency. The supplier's position would not necessarily be weakened, at least, to the extent that retention of title clauses would enjoy a privileged position with respect to priority (with a few exceptions, in principle only simple retention of title enjoys a privilege). The supplier's position would not change in the case of the buyer's insolvency since, whether or not the retention of title is assimilated to a security right, the supplier is protected (see A/CN.9/WG.VI/WP.9/Add.6, para. ...). However, the supplier would need to register (see A/CN.9/WG.VI/WP.9/Add.3, para. ...), and "all sums" clauses, proceeds and products would enjoy priority only as of the time of their registration.

#### 4. Integrated comprehensive security

46. The institution of a single, integrated, comprehensive security right in all types of movable property is inspired by the observation that the different types of non-possessory security rights but also the traditional possessory pledge are all based upon a few identical guiding principles. The main theme is that substance must prevail over form. It is no accident that this idea first developed in federal states, such as the United States of America and Canada. Thus the American Uniform Commercial Code (“UCC”). The UCC, a model law adopted by all fifty states, created a single, comprehensive security right in movables unifying numerous and diverse possessory and non-possessory rights in tangibles and intangibles, including transfer and retention of title arrangements, that existed under state statutes and common law. The idea spread to Canada, New Zealand and a few other countries. The Inter-American Model Law on Secured Transactions follows in many respects a similar approach. The EBRD Model Law follows a similar approach to the extent it creates a specific “security interest” which can work side by side with other security devices (e.g. leasing) and recharacterizes retention of title as a security right.

47. An integrated comprehensive security system presents certain advantages. First, all relevant (which are often great in number) statutes dealing with non-possessory security rights may be merged into one text which ensures comprehensiveness and consistency of the rules. Second, the rules on possessory security rights, especially the possessory pledge may be covered and at the same time adapted to contemporary requirements (e.g. by introducing the notion of control). Third, title devices such as the security transfer and the retention of title may be integrated into the system. Fourth, contractual arrangements that fulfil a security function, such as leasing contracts, sale and resale, may also be included and covered.

48. Consistency is generally desirable with respect to the security transfer of title and the security assignment of receivables. More controversial may be the integration of the retention of title to the extent it is aimed at favouring suppliers’ credit as an alternative to general bank credit. However, these policy objectives may be achieved even in the context of an integrated comprehensive regime through special rules governing the creation, publicity, priority, enforcement and status in the case of insolvency (or any of these aspects) of a retention of title arrangement.

49. The main feature of a broad approach is that substance prevails over form in order to make available to parties all possible forms of security for credit. While this approach may require recharacterization of certain transactions (e.g. transfer of title for security purposes or retention of title), at least for the purpose of secured transactions laws, is to the benefit of grantors, secured creditors and third parties, including the insolvency representative in the grantor’s insolvency. Otherwise, parties could evade publicity requirements and invoke remedies that would give them an undue advantage over other secured creditors.

50. In addition, under this approach, a creditor who envisages granting a secured loan, need not investigate various alternative security devices and evaluate their respective prerequisites and limits as well as advantages and disadvantages. Correspondingly, the burden borne by the grantor’s creditors or the insolvency representative for the grantor who must consider their rights (and duties), vis-à-vis the secured creditor is lessened if only one regime, characterized by a comprehensive security right, has to be examined rather than several different

regimes. Further, this will reduce the cost of creating security and, concomitantly, the cost of the secured credit.

51. In cross-border situations, the recognition of security rights created in another jurisdiction will also be facilitated if the jurisdiction of the new location of encumbered assets has a comprehensive security right. Such a system can much more easily accept a broad variety of foreign security rights, whether of a narrow or an equally comprehensive character.

52. Technically, two approaches can be used to achieve an integrated and comprehensive security right. Under one approach, the names of the old security devices, such as transfer of title, may be preserved and used. However, their creation and effects as security rights are made subject to an integrated set of rules, while they may continue to have their full title effects for other purposes (e.g. taxation or accounting). Under a slightly different approach, the rules applicable to certain basic types of contract that may be used for purposes of security, such as sales, leases or assignments, are supplemented by a general clause providing that, if a sale or lease is used for the purpose of securing claims, certain specified additional rules apply (e.g. with respect to publicity or enforcement). There is no substantive difference between the two approaches with respect to the effects they attribute to security rights.

## **B. Summary and recommendations**

53. In certain, albeit limited, practical situations, the possessory pledge functions usefully as a strong security right (see para. 13).

54. A right of retention of possession created by agreement, if accompanied by the creditor's power of sale, functions as a possessory pledge (see para. 14).

55. Non-possessory security rights are of utmost importance for a modern and efficient regime of secured transactions. Grantors need to retain possession of encumbered assets and secured creditors need to be protected against competing claims in the case of grantor default and in particular insolvency (see para. 15).

56. In light of the growing importance of intangibles as security for credit and the often insufficient rules applicable to this type of asset, it would be desirable to develop a modern legal regime for security in intangibles. Such a regime should be as close as possible to that for non-possessory security rights in tangibles, since: often security is taken over the entirety of a debtor's assets, including both tangibles and intangibles; in the context of transactions relating to security in tangibles (e.g. inventory or equipment financing), security may be taken over intangibles (e.g. intellectual property rights); and intangibles may be proceeds of tangibles. In particular with respect to receivables, the principles of the United Nations Assignment Convention (e.g. assignability of future receivables, validity of bulk assignments and assignments made despite contractual limitations on assignment, debtor protection) should be used as the standard to be followed. As to security rights in excluded intangibles, such as securities, reference could be made to the work of other organizations.

57. With respect to title devices, such as security transfer and retention of title of tangible assets, as well as security assignment of claims and other intangibles, there are two alternatives.

58. Under the first alternative, if a country chooses to adopt a comprehensive security system, subject to certain exceptions, the rules applicable to security rights would apply to title devices as well. Exceptions could refer to a special priority in favour of a supplier (or even a bank financing the purchase of an asset) with a retention of title, possibly subject, in certain cases, to a notice to creditors on the public record (see A/CN.9/WG.VI/WP.9/Add.3, paras. ...).

59. Under the second alternative, if a country has already a developed legal regime for title devices but not for non-possessory security and does not wish to follow an integrated comprehensive approach, two separate systems could be envisaged, one for non-possessory security and another for title devices. Under such an approach, the creation of title devices would be subject to the currently existing rules. No publicity would be required, except with respect to assets for which registration is foreseen in currently existing legislation (e.g ships and aircraft). In the absence of any publicity requirement, however, potential creditors would have to factor the risk of the existence of a retention of title arrangement in their credit terms, a result that may negatively affect the availability and the cost of credit (see para. 43).

60. As to enforcement of a retention of title arrangement, under this alternative, the seller would be able to reclaim the assets from the buyer and to dispose of them as the owner, without having to account to the buyer (except for repayment of any parts of the purchase price paid). In the case of the buyer's insolvency, the insolvency administrator would have to pay the outstanding purchase price to obtain title. If the insolvency administrator chooses not to pay, the seller could reclaim the assets as the owner or insist as a general creditor on the payment of the outstanding purchase price (see para. 41).

61. In the case of enforcement of a security transfer of title under this alternative, at least two approaches are possible since, even in countries that do not follow an integrated comprehensive approach, transfer of title is usually treated either as a title device or as a security device (see para. 32). Where it is treated as a title device, the transferee may enforce its claim as the owner and does not need to account to the transferor for any surplus remaining after disposition of the encumbered assets and satisfaction of the transferee's claim. In the case of insolvency, the assets are not part of the estate but the insolvency administrator may exercise any related contractual rights. Where security transfer of title is treated as a security device, the creditor, after a public or private sale of the transferred assets and satisfaction of the claim secured, has to account for any surplus. In the case of insolvency, the assets are part of the estate and are treated as being subject to a security right (see paras. 33-34). A combination of these two approaches (in which security transfers are treated with respect to creation and certain effects as transfers of title, while with respect to enforcement and insolvency they are treated as security devices) is also possible.

62. There are good reasons for replacing a regime of security rights consisting of a variety of specific security devices by a regime providing for an integrated, comprehensive security right (see paras. 46-52).

**Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fourth session**

ADDENDUM

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## V. Publicity

### A. General remarks

#### 1. Introduction

1. A secured creditor needs to be sure that its rights in the encumbered assets have precedence over the rights of third parties. Yet third parties also need protection against the risk of their rights being subordinate to “secret” security rights (in the sense that their existence or possible existence cannot be easily determined in an objective way). Requiring security rights to be publicized before they take effect against third parties offers a means of reconciling these objectives.

2. This chapter focuses on the four most widely accepted modes of publicity. The first is removing possession of the encumbered assets from the grantor. The second is an extension of the idea of dispossession and involves giving the secured creditor control over the value of intangible obligations owed to the grantor by a third party. The third is available only in respect of high value movables for which a State has established a specialized title registry or title certificate system.

3. The fourth and most comprehensive mode of publicity involves filing a simple notice with a limited amount of data about a security right in a secured transactions registry. Unlike a title registry, a secured transactions registry is not concerned with publicizing the current state of title to specific assets. The quality of the grantor’s title is determined by off-record events and transactions. Instead, registration is a precondition to the effectiveness of a security right against third parties. Thus, it is the absence of publicity upon which third parties rely in determining whether they are potentially bound by a prior security right.

4. Although it operates on a theory of negative publicity, a secured transactions registry also contributes to positive priority ordering. Most obviously, registration



establishes an objectively evidenced and easily verifiable date for ordering priorities among secured creditors and between a secured creditor and other third parties.

5. The entire topic of publicity is inextricably intertwined with that of priority. Although priority is the topic of a separate chapter in this Guide (see A/CN.9/WG.VI.WP.9/Add.3), the nexus between publicity and priority is a continuing theme in this chapter, and the two chapters should be read in conjunction with each other.

6. Like a title registry or title certificate system, the establishment of a secured transactions registry requires governmental investment in the necessary infrastructure whether directly or by contracting with a private sector partner. In the absence of such a system, the third party effectiveness of a non-possessory security right is usually tempered by statutory or judge-made rules designed to protect innocent third parties who acquire a right in the encumbered assets without knowledge of the existence of a prior right. The chapter concludes by comparing a comprehensive registry-based publicity system with this alternative, and by setting forth legislative recommendations.

## **2. Dispossession**

### **a. General considerations**

7. Removing the encumbered assets from the possession of the grantor does not positively publicize the existence of a security right. However, it eliminates the grantor's apparent ownership thereby also reducing the risk of an unauthorized disposition to an unsuspecting third party. Because dispossession signals that the grantor no longer has unencumbered title, it has traditionally been accepted as sufficient to both constitute a security right and make it effective against third parties (see A/CN.9/WG.VI.WP.6/Add.3, para. 67).

### **b. Possession of the encumbered assets by a third party**

8. Dispossession need not involve direct possession by the secured creditor. Possession by a third party on behalf of the secured creditor is sufficient.

9. If the encumbered assets are covered by a document of title (for example, a bill of lading or a warehouse receipt), issuance of the document in the name of the secured creditor ensures that the third party (for example, a carrier or warehouse keeper) is holding on behalf of the secured creditor as opposed to the grantor. If the document of title is negotiable, the carrier or warehouse keeper is normally obligated to deliver the underlying assets to the person currently in possession of the document. It follows that delivery of a properly endorsed negotiable document of title offers an alternative means of removing possession of the underlying assets from the grantor.

10. Possession by a third party does not always require physical removal of the encumbered assets from the grantor's premises. In field warehousing arrangements, a warehousing company acting for the secured creditor assumes control of the grantor's inventory and other encumbered assets through an agent embedded with the grantor. Third parties are protected by virtue of the fact that the grantor's ability to deal with the encumbered assets requires the consent and cooperation of the agent (see A/CN.9/WG.VI.WP.9/Add.1, para.7).

**c. Fictive dispossession**

11. A paper undertaking by the grantor to hold the encumbered assets as agent for the secured creditor does nothing to protect third parties from being misled by the grantor's apparently unencumbered ownership. Neither does requiring the grantor to periodically deliver lists of encumbered trade receivables to the secured creditor. Fictive dispossession techniques like these represent a pragmatic response to the demand for non-possessory security in regimes in which the pledge is the only formally available security device. Recognition of the general effectiveness of non-possessory security rights along the lines contemplated in this Guide (see A/CN.9/WG.VI/WP.9/Add.1, paras. 15-23) eliminates any pressure to countenance fictive pledges.

**d. Priority effects**

12. Even in legal systems with a secured transactions registry, dispossession of the grantor can sometimes constitute a superior mode of publicity. For example, in most jurisdictions, if the encumbered assets are covered by a negotiable document of title, a secured creditor (or buyer) in possession of the document typically takes priority over a secured creditor who publicizes by registration of a notice about its security right (see A/CN.9/WG.VI/WP.9/Add.3, para. 13). This rule avoids interference with the widespread acceptance of negotiable documents of title as the primary vehicle for transferring property rights in the underlying assets during the period that they are covered by the document.

13. In other situations, dispossession may not be the most advantageous mode of publicity. If the encumbered assets are registered in a specialized title registry (see Part A.4), the need to preserve the integrity and reliability of the public record may require giving precedence to secured creditors (and buyers) who publicize their rights by registration.

14. If a competing security right was instead publicized by registration in a general secured transactions registry (see Part A.5), two responses are possible. Priority can be ordered temporally according to the order in which dispossession and registration occurred. Alternatively, preference may be given to the registered security right, regardless of whether dispossession occurred before or after registration.

15. The first approach reduces costs and risk for pawnbrokers and other creditors who routinely rely on possessory security. On the other hand, the second approach averts any temptation on the part of possessory secured creditors to fraudulently antedate the time at which dispossession occurred. It also maximizes the priority ordering value of the secured transactions registry by eliminating the risk for off-record evidence of the precise timing of dispossession.

16. If the first approach is taken, there is the further issue of whether priority dates from the moment of dispossession even if a secured creditor initially publicizes by dispossession and later registers and releases the assets back to the grantor. If so, a second-registered secured creditor would end up having first priority. On the other hand, the first-registered secured creditor could have protected itself by verifying that the grantor was in possession of the encumbered assets at the time that secured creditor obtained its security right.

### **3. Acquisition of control over intangible obligations**

#### **a. Trade receivables**

17. In legal systems that accept the negotiability of security certificates (for stocks or bonds), delivery of the certificate with any necessary endorsement transfers the benefit of the obligations owed by the issuer to the secured creditor. As such, it is the functional equivalent of dispossession through the agency of a third party. The same result can be achieved for certificated securities held with a clearing agency by entering the name of the secured creditor in the books of the clearing agency, and for uncertificated securities, by registering the name of the secured creditor in the books of the issuer. In the case of indirectly held investment property, control over the obligations owed by the broker or other intermediary can be transferred either by putting the investment account in the name of the secured creditor, or obtaining the agreement of the intermediary to respond to the directions of the secured creditor.

18. This Guide does not address issues relating to security rights in investment property. Nonetheless, the idea of control as a mode of publicity equivalent to dispossession can be applied to other types of intangible obligations owed by a third party to the grantor. For example, the grant of security in an ordinary trade receivable or other monetary claim entitles a secured creditor, in the case of debtor default, to demand payment from the person owing the obligation subject to the terms of the security agreement. A demand for payment thus transfers practical control over the monetary claim to the secured creditor. For this reason, it might be considered a sufficient mode of publicity equivalent to the transfer of control over investment property.

19. However, a secured creditor generally will not demand direct payment until there is a default on the part of the grantor. Even when monetary claims are sold outright, the assignee will frequently wish to leave collection in the hands of the assignor. In light of these practicalities, it may be preferable to treat a demand for payment simply as a collection or enforcement technique and not a mode of initial publicity. This is particularly appropriate where the option of filing a notice in a secured transactions registry is available to both secured creditors and assignees. Publicity by registration offers a more efficient means of evaluating priority risk at the outset of the transaction particularly where the security covers the grantor's present and after-acquired receivables.

#### **b. Deposit accounts**

20. By analogy to the mode of publicity used for indirectly held investment property, control over a deposit account held by a grantor with a financial institution or insurance company can be achieved by putting the name of the secured creditor on the account or obtaining the agreement of the depository institution to respond to the directions of the secured creditor.

21. The depository institution may itself be owed money by the grantor. Rather than going through the artificial exercise of requiring a positive transfer of control, it may be simpler to treat a depository institution that takes security in a customer's deposit accounts as having automatic control by virtue of its status.

22. Whether a secured creditor who publicizes the grant of security in a deposit account by control should have priority over one who publicizes by registration is an open question. The analogy to investment property would suggest a positive answer. The analogy to the assignment of monetary claims would suggest the contrary.

23. If the first approach is taken, there is the further question of whether a depository institution that takes security in its customers' accounts should have priority over other security rights publicized by control. The institution's set-off rights are usually sufficient to protect its counter claims prior to the initiation of enforcement proceedings by a competing secured creditor, independently of whatever priority status the institution has as a secured creditor.

#### **4. Title-based modes of publicity**

##### **a. Title registry systems**

24. Dispossession and equivalent control techniques are available only if the grantor is prepared to give up ongoing use and enjoyment of the encumbered assets. They are not feasible for publicizing security rights in assets over which the grantor needs to retain control in order to produce its services or products or otherwise generate profit.

25. For limited categories of high value movable assets, a State may have adopted a specialized title registry similar to a land title registry. Where a title registry exists, it offers a convenient venue for publicizing non-possessory security rights in such high-value assets. Ships, aircraft, motor homes, and intellectual property rights (notably patents and trade marks) are the most commonly encountered examples of assets for which title registries exist.

26. A security right (or sale) publicized by registration in a title registry generally takes priority over a security right publicized by dispossession or by registration of a notice of security in a general secured transactions registry. This rule ensures that purchasers of the encumbered assets can rely with full confidence on the title registry records in assessing the quality of the title they are obtaining.

27. Providing a common access point to the records of the title registry and the secured transactions registry so as to enable simultaneous registration and searching of both systems could also accommodate this concern. Advances in computer technology make this feasible as a technical matter. However, there are design and implementation challenges. Title registry systems are generally based on asset-indexing while secured transactions are generally organized by reference to the identity of the grantor. Thus, to enable simultaneous searching, it would be necessary to require both systems to implement the same grantor identifier rules, and to program the title registry to permit grantor-based searching.

##### **b. Title certificate systems**

28. Title certificate systems are an alternative method used by some States to publicize the acquisition and transfer of title in movable assets (for example, motor vehicles). Security rights are publicized by a notation on the certificate.

29. A security right publicized by a notation on a title certificate generally takes priority over one publicized by any other method. This rule is necessary if

purchasers are to be able to rely on the title certificate in assessing the quality of the seller's title.

**c. Security rights in land-related movables**

30. Financing flexibility is enhanced if the regime for security in movables is available to secured creditors who take security in immobilized movables (e.g. a furnace destined to be attached to land), or in mobilized immovables (e.g. growing crops destined to be severed from the land). This would allow a grantor to obtain financing without having to take out a full-fledged and correspondingly more expensive immovables mortgage.

31. Under this approach, the general publicity rules for movables can be applied with one qualification. It would be desirable to require concurrent registration of a notice of security in the immovables title registry to bind third parties who later acquire a registered right in the land to which the movables are attached or affixed, and to apply the priority rules applicable to immovables to such relationships. These rules would preserve the integrity and reliability of the land title record.

**5. Registration of the security agreement in a secured transactions registry**

32. Another mode of publicity relates to the registration of the security agreement in a secured transactions registry. As is the case with registration in title registries, documents are submitted to and checked by the registrar who then issues a registration certificate that constitutes conclusive evidence of the existence of the registered right. This conclusive evidence certificate is often recognized as the main advantage of document registration. However, the purpose of establishing priority for the registrant while, at the same time, protecting the interests of third parties may be achieved in a more cost- and time-efficient way, that better addresses the needs of modern transactions and does not result in disclosing sensitive data relating to a transaction (see A.5).

**6. Registration of a notice of security in a secured transactions registry**

**a. General considerations**

33. A fifth mode of publicity involves filing a notice of the security right in a public registry established for this purpose. Unlike the three modes of publicity already considered, notice filing offers a universal means of effecting publicity, regardless of the nature of the encumbered assets. As such, it contributes to efficient priority ordering, enabling competition among secured creditors and between a secured creditor and other third parties to be settled by reference to the timing of registration.

34. A notice-based secured transactions registry is very different from a title registry or a secured transactions registry based on document filing. A title or a document-filing registry functions as a conclusive source of positive information about the current state of title to specific assets. To protect the integrity of the title record, the registrant is generally required to file the actual title transfer documents or tender them for scrutiny by the registrar.

35. In contrast, a secured transactions notice-filing registry operates on a theory of negative publicity. Registration does not provide positive proof of the existence of

the security right. It rather provides a warning to third parties about the possible existence of a security right that allows third parties to take further steps to protect their rights (see para. 54) and constitutes a precondition to the effectiveness of a security right against third parties. In effect, it is the absence of registrations on which third parties rely in concluding that they need not worry about any prior security rights granted by the person with whom they are dealing. It follows that there is no need to require secured creditors to register the security agreement or otherwise prove its existence. Third parties are sufficiently protected by registration of a simple notice identifying the parties and describing the encumbered assets. From the grantor's perspective, protection from unauthorized registrations can be achieved by the registry rules' requiring the named grantor to be informed of any registration and by establishing a summary administrative procedure to facilitate the removal of unauthorized registrations.

36. Notice filing greatly simplifies the registration process and minimizes the administrative and archival burden on a registry system. It also enhances flexibility during the duration of the financing. So long as the factual particulars set out in the registered notice are not affected, there is no reason why a single notice cannot be accepted as sufficient to publicize successive security agreements between the parties.

37. The concept of a notice-based secured transactions registry has attracted considerable international support. Model systems have been developed by the European Bank for Reconstruction and Development (General Principles of A Modern Secured Transactions Law, 1997; Model Law on Secured Transactions, 1994), the Organization of American States (Model Inter-American Law on Secured Transactions, 2002), and the Asian Development Bank (Law and Policy Reform at the Asian Development Bank: A Guide to Movable Registries, December 2002). The Convention on International Interests in Mobile Equipment, 2001 and the related Aircraft Protocol provide for an international priority regime based on a filing system for interests in aircraft arising under security agreements, leases and title retention sales agreements. The United Nations Assignment Convention also offers notice filing as one of the optional priority systems set forth in its annex.

**b. Asset v. grantor indexing**

38. A notice of security must be indexed according to established criteria to permit its efficient retrieval. Notices in a secured transactions registry are generally indexed by reference to the identity of the grantor. Asset-based indexing is feasible only for assets that have a serial number or other objectively established unique identifier. Even then, the value of individual items within a generic category (e.g. all tangible movables) may be too modest to justify the cost involved in tracking registrations on an item-by-item basis. In addition, asset-based indexing does not accommodate the registration of a notice covering security in after-acquired assets, or circulating funds of assets, for example inventory and receivables.

39. Grantor-based indexing greatly liberates the registration process. Secured creditors can publicize a security right in all of a grantor's present and after-acquired movable property, or in generic categories, through a single one-time registration. They need not worry about updating the record every time the grantor acquires a new item within the generic category set out in the notice.

40. Grantor-based indexing has one drawback. If the encumbered assets become the object of unauthorized successive transfers, prospective secured creditors and buyers cannot protect themselves by conducting a search according to the name of the immediate apparent owner. Because the system is grantor-indexed, the search will not disclose a security right granted by a predecessor in title.

41. A partial solution to this problem would be to require asset-based indexing for particularly high-value assets for which reliable numerical identifiers exist, for example, road vehicles, boats, motor homes, trailers, aircraft, and so forth. Although specific asset identification limits the ability to use a single notice to publicize security in after-acquired assets, it is practically necessary only for capital assets used in the grantor's business (and consumer assets used for personal purposes to the extent these are covered by the registry). In cases where the assets are held by the grantor as inventory, a buyer in the ordinary course of business will take free of the security right in any event.

42. An alternative or complementary approach would be to require secured creditors who find out about a transfer by the grantor to add the transferee as an additional grantor on the registered notice so as to avoid subordination to intervening third party claimants. Alternatively, protection might be extended to all intervening buyers, or even all intervening third parties, even where the secured creditor has no knowledge of the debtor's unauthorized disposition (see also A/CN.9/WG.VI/WP.9/Add.3, para. 40).

**c. Content of registered notice**

**i. Identification of grantor**

43. Since grantor identity is the usual means by which notices of security are retrieved, registrants and searchers require guidance on the correct mode of identification. The grantor's name and address is the most common criterion.

44. For corporate grantors and other legal persons, the correct name can usually be verified by consulting the public record of corporate and commercial entities maintained by most States. If the information in this record and in the secured transactions registry is stored in electronic form, it may be possible to provide a common gateway to both records to simplify the verification process.

45. For individual grantors, verification of the correct name is a little more challenging. There may be inconsistencies between the grantor's popular and formal birth names, or between the names that appear on different identity documents. Name changes may have occurred since birth as a consequence of deliberate choice or a change in marital status. The provision of explicit legislative guidance to deal with these various contingencies ensures that registrants and searchers are operating according to the same criteria. For example, the regulations or administrative rules might specify a hierarchy of official sources, beginning with the name that appears on the grantor's birth certificate, and then referencing other sources (for example, a passport or driver's licence) in situations where there is no official birth record or it is inaccessible.

46. If more than one grantor shares the same name, the provision of the grantor's address will often resolve the identity issue for searchers. In States where many individuals share the same name, it may be useful to require supplementary

information, such as the grantor's birth date. If a State has adopted a numerical identifier for its citizens, this can also be used, subject to privacy concerns, and subject to prescribing an alternative identifier for grantors who are non-nationals.

47. The impact of an error in the grantor's name on the legal validity of a notice depends on the organizational logic of the particular registry system. For instance, some electronic records are programmed to disclose only exact matches between the name entered by the searcher and the names appearing in the database. In such a system, any error will nullify the registration because it will render the notice irretrievable by searchers using the correct name of the grantor. In other systems, it may be possible to also retrieve close matches in which event the registered data may well turn up on a search using the correct identifier notwithstanding the entry error. Whether the error nonetheless invalidates the registration depends on the particular case. A useful flexible test would be to treat the error as fatal only if the information disclosed on the notice would mislead a reasonable searcher.

#### **ii. Identification of secured creditor**

48. Entry of the name and address of the secured creditor or the secured creditor's representative on the registered notice enables third parties to contact the secured creditor if necessary and ensures that a person who later claims a priority benefit based on the notice is the person entitled to do so. The rules used for determining the correct name of a grantor can also be applied to secured creditors. However, the name of the secured creditor is not an indexing criterion. Consequently, registration errors do not pose the same risk of misleading third party searchers so as to nullify the notice.

#### **iii. Description of encumbered assets**

49. There is no absolute necessity to require a notice of a security right to include a description of the encumbered assets. However, the absence of a description would hamper the ability of a grantor to sell, or grant security in, assets that remain unencumbered. Prospective buyers and secured creditors would require some form of protection (for example, a release from the secured creditor) before entering into transactions involving any of the grantor's assets. The absence of a description would also diminish the value of the notice for insolvency administrators and judgement enforcement creditors.

50. For these reasons, a description of the encumbered assets is normally required. In a grantor-indexed system, there is no need to require a specific item-by-item description. The information needs of searchers are sufficiently served by a generic description (e.g. all tangible assets, all receivables) or even a super-generic description (e.g. all present and after-acquired movables). Indeed, generic description is necessary to ensure the efficient publicity of a security right granted in after-acquired assets, and in circulating funds or universalities of assets (e.g. "all claims" or "all inventory").

51. A more difficult question is whether the notice need only indicate the generic nature of the encumbered assets (e.g. tangible movables), even if the security right is in fact limited to a specific item (e.g. a single automobile), or whether the description should have to conform to the actual range of assets covered by the background security documentation.



52. The first approach simplifies the registration process and reduces the risk of descriptive error. It also permits the parties to amend their security agreement to add new assets within the same generic category without the need to make a further registration. On the other hand, this approach may complicate grantor access to financing against the unencumbered portion of the described assets. Since priority dates from the time of registration, subsequent buyers and secured creditors will require an explicit waiver or discharge to protect them against the risk that the grantor may later expand the actual scope of the assets covered by the initial security agreement.

**iv. Maximum value of secured obligation**

53. A further question is whether the notice must disclose the monetary value of the secured obligation. It is not desirable to require the actual or intended value to be set out because this would interfere with the flexibility of line of credit and instalment financing. However, secured creditors could be required to specify the maximum amount to be secured by the security right. This approach would facilitate the grantor's ability to use the residual value of assets subject to a broad security right to secure further financing from other secured creditors. On the other hand, the first secured creditor to take a general security right over the grantor's assets is typically the cheapest and most available source of credit. In addition, the value of imposing such a requirement would be lost if inflated estimates were routinely filed.

**d. Access to more detailed information**

54. Prospective buyers and secured creditors can generally deal with the priority risk presented by a registered notice without having to investigate further. They can refuse to deal further with the grantor, or obtain a release or subordination agreement from the registered secured creditor, or require the grantor to bring about a discharge of the registration (in cases where the registration does not represent a charge or where a new secured creditor is prepared to advance sufficient funds to pay out the prior registered secured creditor).

55. Third parties in the position of unsecured creditors and insolvency representatives, along with co-owners of the encumbered assets, are in a somewhat different position. They already have an existing or potential claim against the encumbered assets. However, the value of that claim can be assessed only by access to off-record evidence of the security agreement and the current amount of the outstanding obligation. Since the grantor of the security right may not be a reliable or cooperative source of this information, it may be desirable to impose a legal obligation on secured creditors to directly respond to a demand by third parties with a legitimate interest for further details within a reasonable time.

**e. Duration of registration**

56. The duration of secured financing relationships can vary considerably. The necessary flexibility can be accommodated in one of two ways. The first is to allow registrants to self-select the desired term of the registration with a right to file renewals. The second is to set a universal fixed term (e.g. five years), also accompanied by a right to file renewals.

57. In medium- and long-term financings, the first approach lessens the risk for secured creditors of a loss of priority for failure to renew in time. In short-term arrangements, the second approach reduces the risk for grantors that secured creditors will register for an inflated term out of an excess of caution.

58. Regardless of which approach is adopted, it is necessary from the perspective of the grantor to ensure that notices are expunged from the record within a reasonable period after the secured obligation is satisfied. Possible solutions include the imposition of a financial penalty on secured creditors who fail to register a timely discharge combined with the establishment of a summary administrative procedure for compelling discharge if the secured creditor fails to respond to a justified demand to do so by the grantor. As an added incentive to timely action, it may be desirable to give secured creditors the right to register a discharge free of charge.

**f. Administrative issues**

**i. Technological considerations**

59. If the registry records are organized on a regional or district basis, complicated rules are needed to determine the appropriate registration venue and to deal with the consequences of a relocation of the assets or the grantor. On the other hand, a single national registry creates inequalities of access. Computerization of the registry data base resolves the problem by enabling all registrations to be entered into a single central record while also allowing for remote registration and searching.

60. An electronic database can support a fully electronic registration system, in which clients have direct computer access to the electronic data base for both registration and searching. This significantly reduces the costs of operation and maintenance of the system. It also enhances the efficiency of the registration process by putting direct control over the timing of entry into the hands of the registering party, and eliminating any time lags between submission of a notice and the actual entry of the information contained in the notice into the database. Perhaps most importantly, a fully electronic system places all responsibility for accurate data entry on registrant and searchers, thereby minimizing staffing and operational costs.

61. Ultimately, the optimal extent of computerization depends on the level of computer literacy among the registry client base, the reliability of existing communications infrastructure, and on an assessment of whether expected revenues will be sufficient to recover the initial capital costs of construction within a reasonable period. The overall objective is to make the registration and searching process as simple, transparent and accessible as possible within the context of the particular State.

**ii. Liability for system error**

62. If the system is exclusively electronic, there is no risk of human error on the part of the registry office at either the registration or searching stages. The responsibility is cast on the registrants and searchers. As for the risk of system breakdown, the consequences can usually be alleviated by prompt notification of clients and by extending any time periods that might have run out during the breakdown period. To the extent input of data and the entry of searches is carried out by registry staff, the risk of human error in transposing and retrieving data is

present although this too can be alleviated by establishing electronic edit checks and ensuring the timely return to the client of a copy of the registration data or search result.

63. Whatever the design of the system, guidance needs to be given concerning the responsibility, and the limits of responsibility for registry staff or registry system error. One compromise solution would be to allocate a portion of the registry revenues to a mandatory compensation fund and to impose an upper limit on the amount of compensation for any single incident.

64. Assuming a compensation claim is available, further guidance is needed on who carries the risk of error as between registrants and third party searchers. In resolving this issue, the rules might, for example, provide that an indexing error on the part of registry staff does not prejudice the publicized status of a security right except as against secured creditors or purchasers who can positively establish that they searched and suffered actual damage as a result of acting to their detriment on the misleading information contained in the record.

### **iii. Registration fees**

65. High registration and search fees designed to raise revenue rather than support the cost of the system are tantamount to a tax, ultimately borne by grantors, on secured transactions. To encourage access to secured credit at a reasonable cost, it is critical for the success of the system to set fees at a nominal level that encourages use of the system, while still enabling the system to recover its capital and operational costs within a reasonable time.

### **iv. Privacy and confidentiality considerations**

66. A notice-based registration system enhances the confidentiality of the grantor's and secured creditor's relationship by limiting the level of detail about the parties' relationship that appears on the public record.

67. The topic of confidentiality raises the issue of whether the system should be organized to facilitate searching against the name of the secured creditor as well as the grantor. While the quantity and content of notices filed by a particular financial institution or other creditor entity is not relevant to the legal mission of the registry, this kind of information may have market value as a source of a competitor's customer lists or for companies seeking to market related financial or other products. Although the additional revenues would be attractive, the retrieval and sale of this kind of bulk information is likely to damage trust in the system and may well violate privacy laws.

## **g. Priority effects**

### **i. Advance registration**

68. The establishment of a secured transactions registry enables competing registered security rights in the same encumbered asset to be resolved according to a general first-to-register rule. The exceptions to this general rule are dealt with in detail in the chapter on priority (see A/CN.9/WG.VI/WP.9/Add.3, paras. 12-17). However, an issue that is relevant at this stage is whether a secured creditor should be permitted to file a notice of security in advance of the actual conclusion of the

security agreement (a notion similar to the pre-notation of a mortgage in a land registry).

69. Advance filing enables a secured creditor to establish its ranking against other secured creditors without having to check for further filings before advancing funds. Advance filing also avoids the risk of nullification of the registration in cases where the underlying security agreement happens to have been technically deficient at the point of registration but is later rectified, or where there are factual uncertainties as to the precise time when the security agreement was concluded.

70. From the perspective of the grantor, adequate protection from the risk that no security agreement ultimately emerges can be assured through the same measures used in the case of unauthorized registrations (i.e. by requiring that the named grantor be informed of any registration and by establishing a summary administrative procedure to enable the grantor to compel a discharge if the identified secured creditor fails to act within a reasonable time).

## **ii. Qualifications on priority**

71. It was pointed out in earlier parts of this chapter that registration may not always be the optimal mode of publicity from the point of view of priority, as for instance, where the encumbered assets consist of investment property publicized by control, or where they are subject to a title registry or title certificate system (see paras. 17-19 and 26-33).

72. In addition, while registration may be a precondition to the effectiveness of a security right, a registered security right is not necessarily effective against all categories of third parties. For instance, a purchaser of inventory sold in the ordinary course of the seller's business normally takes free of any security right granted by the seller. Similarly, the existence of a security right typically does not impair the rights acquired by a lessee or licensee of encumbered assets subject to a registered security right. Finally, third parties who acquire possession of cash or negotiable assets for value in the ordinary course of business are usually protected from a prior registered security right.

73. These rules are addressed in detail in the chapter on priority (see A/CN.9/WG.VI/WP.9/Add.3, paras. 34-43). The important point for the purposes of this chapter is that the registration of a notice of security does not interfere with the freedom of third parties to engage in ordinary-course-of-business commercial transactions with the grantor involving the encumbered assets without any worry about having to search the secured transactions registry or indeed being bound by a registered security right of which they happen to be aware.

## **h. Registration and enforcement**

74. In some legal systems, a secured creditor is required to register a notice of default and enforcement before being entitled to exercise its enforcement remedies against the encumbered assets. In other legal systems, registration is not a precondition to enforcement. The question of which approach should be taken depends, in part, on who bears the responsibility for notifying third parties with a registered interest in the encumbered assets of the initiation of enforcement action. If this burden is imposed on the secured creditor directly, registration may not be needed. If the burden is instead placed on the registrar or some other public official,

then registration is needed in order to trigger the relevant official's obligation to notify other registered claimants.

75. Advance registration of intended enforcement action may help to reduce the inquiry burden for competing creditors, both secured and unsecured, who are contemplating the initiation of enforcement action. Otherwise, they will have to make further inquiry of all registered secured creditors in order to determine whether enforcement already has been initiated by any of them. While some level of inter-creditor communication is invariably needed in practice in order to ensure adequate coordination, registration would at least enable creditors to focus their inquiry efforts (see A/CN.9/WG.VI/WP.9/Add.5, paras. ...).

**i. Extension of registry to non-security transactions**

**i. Title and similar devices**

76. A security right may sometimes be granted through the device of a transfer of title to the secured creditor under a "sale" or "trust" on the understanding that title is to be reconveyed on satisfaction of a credit obligation owed by the buyer or beneficiary (see A/CN.9/WG.VI/WP.9/Add.1, paras. 29-45). Since the rationale for requiring publicity applies regardless of the form of the transaction, legal systems with modern, comprehensive secured transactions laws adopt a broad approach that sweeps in all transactions that function to secure an obligation owed to a creditor.

77. However, secured transactions are not the only transactions that create problems of publicity. The existence of any property right poses risk for third parties dealing with the apparent owner. Moreover, these other rights may devalue the priority status of a security right to the extent they are not publicized.

78. One means of alleviating these problems is to extend the same publicity requirement that applies to security rights to all commercial transactions in movables that are likely to create significant publicity concerns. As a practical matter, this would involve making registration of a notice in the secured transactions registry a precondition to the third party effectiveness of the transaction.

79. The most obvious categories of common place transactions that might qualify for inclusion are:

- A sale of tangible assets subject to retention of title as security for the purchase price;
- A lease of tangible assets of significant duration (e.g. one year);
- An outright assignment of monetary claims;
- A consignment for sale of tangible assets;
- A non-consensual security right in movable assets created by operation of law.

80. Whether the priority rules that apply to registered security rights should also apply to these transactions is a more complex question. The first-to-register rule has obvious utility where an assignment of claims comes into competition with a security right granted in the same claims. However, in the case of a lease, a consignment, or a retention of title sale, temporal priority ordering has to be qualified in order to preserve the lessor's, the seller's or the consignor's title as against prior registered security rights, perhaps subject to the requirement that

registration be effected within a set time period after the transaction. These details are taken up in the chapter on priority (see A/CN.9/WG.VI/WP.9/Add.3, paras. 21-33).

81. The extension of the publicity and priority rules applicable to secured transactions to other commercial dealings is reflected at the international level in two conventions. The first is the Convention on International Interests in Mobile Equipment which extends the international registry contemplated by the Convention beyond charges to also include retention of title agreements in favour of sellers and aircraft leasing arrangements. The second is the United Nations Assignment Convention under which the choice of law rules governing issues of publicity and priority apply to both the outright assignment and the grant of security in receivables.

## **ii. Judgement creditors**

82. A judgement creditor may be authorized to register a notice of judgement in the secured transactions registry, with registration automatically creating the priority equivalent of a general security right against the judgement debtor's movables. This approach might indirectly promote the prompt voluntary satisfaction of judgement debts since the effect would be to impede the judgement debtor from selling or granting security to third parties without having first paid the judgement debt and having the registration discharged.

83. If this approach is adopted, it is necessary to ensure that the judgement creditor's right does not conflict with insolvency policies requiring equality of treatment among the grantor's unsecured creditors. This can be resolved by a rule in which the insolvency representative automatically acquires the right to any pre-existing judgement right for the benefit of all creditors (perhaps subject to a special privilege in favour of the registered judgement creditor to compensate for registration expenses and efforts; see also A/CN.9/WG.VI/WP.9/Add.3, paras. 44-49).

## **7. Other modes of publicity**

84. Some legal systems substitute more limited notice venues for a public registry (for instance, entry of a notice in the grantor's own books, or in the books of a notary or court official, or in newspapers in the grantor's locale, or in some government journal). Although certain of these notice venues sufficiently address concerns with fraudulent antedating, in comparison to a comprehensive secured transactions registry, they lack the permanence and ease of public accessibility needed to adequately protect third parties.

85. Some legal systems require publicity in the form of affixation of a plaque or other form of physical notice to the encumbered asset. The reliability of such a publicity mechanism is limited in view of the potential for abuse by the grantor. However, in some markets, the specialized nature of the asset and industry practice may make this form of symbolic possession acceptable (e.g. branding of cattle).

## **8. Effectiveness of unpublicized security rights**

### **a. Against the grantor**

86. Publicity is concerned with the third party effects of security rights. It would seem to follow that publicity is unnecessary to constitute an effective security right as between the secured creditor and the grantor.

87. In any event, for most issues involving the immediate parties, the relationship between publicity and the creation of a security right is not practically relevant. After all, the secured creditor has contractual rights against the relevant assets from the moment that the security agreement is concluded. So long as the grantor is the only other party involved, it does not matter whether the secured creditor's rights are characterized as proprietary or personal in nature.

**b. Against third parties**

**i. General considerations**

88. There are three possible responses to determining the legal efficacy of an unpublicized security right against third parties. The first is to treat security rights as effective as soon as they are created subject to special protection for specified classes of third parties, for example those who rely to their detriment on the grantor's apparent ownership. The second is to make publicity an absolute precondition to the third-party effects of security rights. The third is to require publicity only as against specified categories of third-party rights.

89. In light of the diversity of potential responses, it may be more useful to examine the issue of the effectiveness of an unpublicized security in relation to each of the principal categories of competing claimants.

**ii. Competing secured creditors**

90. If non-possessory security rights are allowed to take effect against competing secured creditors without publicity, the direct costs of secured transactions are minimized and there is no need to invest in the establishment of a general secured transactions registry. On the other hand, publicity enables all prospective secured creditors to more accurately assess their priority risk. In its absence, they must rely on the assurances of the grantor, and their own inquiries and perceptions. This additional investigatory burden may impede access to credit by prospective borrowers without an established credit record, and restrict credit market competition.

91. If publicity is required, there is the further question of whether actual knowledge compensates for lack of publicity. If so, an unpublicized security right would trump a publicized security right acquired with knowledge of a prior unpublicized security right. This potentially undermines the certainty and predictability created by a general publicity rule and the value of the first-to-register rule in the context of competing security rights publicized by registration of a notice in a secured transactions registry. Moreover, there is no unfairness or bad faith inherent in requiring the first in time creditor to bear the consequences of failing to effect timely publicity.

**iii. Transferees of encumbered assets**

92. By virtue of the proprietary character of security rights, a secured creditor is presumptively entitled to follow the assets into the hands of a third-party buyer who

acquires title under an unauthorized sale by the grantor (*droit de suite*). In the absence of a publicity requirement, preservation of the secured creditor's *droit de suite* must be balanced against the need to protect the certainty of sales of movables. This may require a rule protecting the title acquired by buyers who take without actual or presumptive knowledge of an unpublicized security right. A publicity requirement dispenses with the need to choose between these two values. Buyers can protect themselves in advance of the purchase by verifying the grantor's possession or control of the encumbered assets and by conducting a search of the secured transactions registry or title registry as the case may be (and buyers in the ordinary course of business or buyers in good faith and possibly other unsophisticated buyers may be exempted from the obligation to register or search; see A/CN.9/WG.VI/WP.9/Add.3, paras. 34-43).

93. There is the further question of whether an unpublicized security right should be effective against a buyer who acquires an encumbered asset with actual knowledge. Priority rules that turn on actual knowledge require a fact-specific investigation of a subjective state of mind, particularly difficult in the context of corporations and other artificial persons. As such, they complicate dispute resolution. A compromise solution may be to treat an unpublicized security right as ineffective only as against buyers who acquire both title and possession of the encumbered assets. This would amount to treating the buyer's possession as a pre-emptive act of publicity.

#### **iv. Donees**

94. The position of a donee of encumbered assets is somewhat different than that of a buyer or other transferee for value. Because the donee has not parted with value, there is no objective evidence of detrimental reliance on the grantor's apparently unencumbered ownership. For this reason, there may be no harm in requiring the donee to respect the prior grant of security regardless of publicity. Against this, one must balance the additional dispute resolution resources involved in settling the status of a transferee and dealing with the possible complications created by a change of position on the part of the donee subsequent to the gift.

#### **v. Insolvency representatives**

95. In the absence of a publicity requirement, a security right is normally effective against the grantor's insolvency representative or judgement creditors, provided it is granted before insolvency proceedings are initiated (or before any pre-insolvency suspect period begins to run). This is sometimes justified on the basis that the unsecured creditors did not rely on the grantor's unencumbered ownership in extending credit. Even if they did, the very act of having extended credit without taking security implies an acceptance of the risk of subordination to the claims of subsequent secured creditors.

96. On the other hand, requiring publicity in advance of insolvency proceedings offers protection against the risk of fraudulent antedating of security instruments. Even more significantly, it reduces the cost of the insolvency by giving the insolvency representative an efficient means of ascertaining which security rights are presumptively effective (see A/CN.9/WG.VI/WP.9/Add.6, para. 2). Outside of formal insolvency, publicity likewise enables judgement creditors to determine in



advance of initiating costly execution action whether the debtor's assets are already encumbered by security (see A/CN.9/WG.VI/WP.9/Add.6, para. 49).

## **B. Summary and recommendations**

97. Removing the encumbered assets from the possession of the grantor is the traditional mode of publicizing the grant of a security right in movable assets. Although dispossession does not positively communicate that the absent assets are subject to a security right, it does alert third parties to the risk that the grantor no longer has unencumbered title. However, to achieve this result, dispossession must be real, not fictive. If the grantor retains apparent ownership, third parties are not protected.

98. Physical dispossession is not feasible where the encumbered assets consist of intangible obligations owed to the grantor by a third party. However, the functional equivalent of dispossession can be obtained by transferring legal control over the performance obligation owed by the third party to the secured creditor. For example, control over a deposit account held with a financial institution or insurance company can be transferred by placing the account in the name of the secured creditor or obtaining the agreement of the depository institution to respond to directions by the secured creditor.

99. For monetary claims, a secured creditor can generally obtain legal control by notifying the third party obligated on the claim to make payment directly to the secured creditor. Nonetheless, it may not be desirable to recognize this as a sufficient act of publicity. Such a rule would require prospective secured creditors, prospective assignees, and other third parties to find out whether notification had been made by a prior secured creditor in order to assess their priority risk. The inquiry burden would impede secured financing based on the grantor's general fund of present and after-acquired trade receivables.

100. Physical dispossession or the transfer of control is not workable if the grantor needs to retain use of the encumbered assets in the course of its business. Many States have established specialized title certificate or title registry systems for limited categories of high value assets, such as road vehicles, ships, aircraft and patents. Where these exist, they offer an acceptable alternative mode of publicity since third parties dealing with the grantor can protect themselves by conducting a search of the title registry, or examining the notations on the title certificate.

101. Title- or asset-based modes of publicity are not practical for security rights in generic funds of present and after-acquired assets, such as inventory, or rights in specific assets for which title-tracking is not economically worthwhile. The only feasible publicity solution here lies in the establishment of a secured transactions registry in which a notice of the security right can be filed by reference to the name of the grantor of the security right.

102. In the absence of a comprehensive secured transactions registry, there is no point in requiring publicity as a precondition to the third party effectiveness of a security right. Assuming the property rules for constituting an effective security right are satisfied, the secured creditor's rights against third parties would instead be assessed by reference to priority rules based on the policy question of which

categories of third party claimants ought to take free of a security right of which they have no knowledge or means of knowledge.

103. Consequently, States interested in introducing a comprehensive secured transactions registry with a view to developing competitive financial markets should establish a comprehensive secured transactions registry for publicizing notices of security rights to enable potential secured creditors and third parties to assess their priority risk with greater certainty and predictability. If so, priority rules should address a number of questions, including:

(a) Whether registration confers superior priority in a competition with a competing security right that was publicized by dispossession or control;

(b) Whether publicity by way of dispossession or control confers superior priority as against competing buyers and secured creditors for some categories of encumbered assets, for example, negotiable instruments in the interest of preserving negotiability;

(c) If the encumbered assets are covered by a specialized title registry or by notation on a title certificate, whether competing security rights and other third party rights that are publicized through these regimes trump a security right publicized by dispossession or by registration in a general secured transactions registry;

(d) In the case of a grantor-indexed registry, what is the most appropriate means of addressing the particular publicity concerns faced by a remote transferee of assets that are the subject of a registered notice, that is, one who acquires the encumbered assets from a successor in title to the grantor. If the secured creditor has not amended the notice to add the name of the transferor, the question arises whether the security right should nonetheless be effective against a transferee without actual knowledge. Alternatively, the question is whether specific asset-based registration should be a precondition of the third party effectiveness of a security right in encumbered assets that have a relatively high value and for which an active resale market exists (e.g. automobiles, motor boats, motor homes);

(e) What are the requirements for a legally effective registered notice. In particular: what constitutes an adequate identification of the grantor and an adequate description of the encumbered assets; whether the maximum value of the obligation capable of being secured by the encumbered assets should be specified in the registered notice; whether the effective duration of a registration, subject to timely renewal, should be determined by reference to the term selected in the registered notice or by reference to a standard term established by law; whether registration in advance of the actual conclusion of any security agreement is permissible; whether a single registration can publicize security granted under successive security agreements between the same parties and covering the same assets;

(f) What techniques are available to protect a grantor from unauthorized or erroneous registrations;

(g) Whether certain categories of third parties are entitled to demand further information about the current status and details of the financing arrangement from the secured creditor directly, notably, co-owners, unsecured judgement creditors, and the grantor's insolvency representative;

(h) What is the optimal policy on design and operational issues, in particular, the establishment of registration and search fees and extent of computerization of the system;

(i) Whether registration is a precondition to the third party effectiveness of other non-possessory dealings in movable assets even though they do not secure performance of an obligation, for example, a long-term lease of tangible movables, a sale subject to retention of title pending payment of the price, an outright assignment of intangible claims.

**Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fourth session**

ADDENDUM

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## VII. Priority

### A. General remarks

#### 1. The concept of priority and its importance

1. The term “security right”, as used in this Guide, refers to an *in rem* right (i.e. a right in property granted to a creditor to secure the payment or other performance of an obligation). The term “priority”, on the other hand, refers to the extent to which the creditor may derive the economic benefit of that right in preference to other parties claiming an interest in the same property (see A/CN.9/WG.VI/WP.6/Add.1, para. 14, definition of “priority”). As discussed below, these competing claimants may include holders of consensual security rights in the property, holders of unsecured debt, sellers of the property, buyers of the property, holders of non-consensual security rights in the property (such as security rights arising from judgements or created by statute) and the insolvency representative of the grantor.

2. The concept of priority is at the core of every successful legal regime governing security rights. It is widely recognized that a priority rule is necessary to promote the availability of many forms of low-cost secured credit. Priority makes it possible for grantors to create more than one security right in their assets, thus utilizing the full value of their assets to obtain more credit which is one of the key objectives of any effective and efficient secured transactions regime; see A/CN.9/WG.VI/WP.6/Add.1, para. 27). In addition, to the extent that priority rules are clear and lead to predictable outcomes, creditors, even unsecured creditors, are able to assess their positions in advance of extending credit and to take steps to protect their rights, which reduces the risks to creditors and thereby has a positive impact on the availability and the cost of credit.

3. A creditor will normally extend credit on the basis of the value of specific property only if the creditor is able to determine, with a high degree of certainty at the time it extends the credit, the extent to which other claims will rank ahead of its security right in the property. The most critical issue for the creditor in this analysis is what its priority will be in the event of the grantor’s insolvency, especially where the encumbered asset is expected to be the creditor’s primary or only source of repayment. To the extent that the creditor has any uncertainty with respect to its priority at the time it is evaluating whether to extend credit, the creditor will place less reliance on the encumbered asset. This uncertainty may increase the cost of the credit to reflect the diminished value of the encumbered asset to the creditor, and may even cause the creditor to refuse to extend the credit altogether.

4. To minimize this uncertainty, it is important that secured transactions laws include clear priority rules that lead to predictable outcomes. The existence of such rules, together with efficient mechanisms for ascertaining and establishing priority at the time credit is advanced, may be as important to creditors as the particulars of the priority rules themselves. It often will be acceptable to a creditor that certain

competing claimants have a higher priority, as long as the creditor can determine that it will ultimately be able to realize a sufficient value from the encumbered assets to repay its claim in the event of non-payment by the grantor. For example, a creditor may be willing to extend credit to a grantor based upon the value of the grantor's existing and future inventory, even though the inventory may be subject to the prior claims of the vendor who sold the inventory to the grantor, or of the warehouseman who stored the inventory for the grantor, as long as the creditor can determine that, even after paying such claims, the inventory may be sold or otherwise disposed of for an amount sufficient to repay its secured obligation in full. Of course, although the focus of the Guide is on consensual security rights, an effective secured transactions law must also include rules for resolving priority conflicts between consensual and non-consensual security rights as well.

5. It is important to note that no matter what priority rule is in effect in any jurisdiction, it will only have relevance to the extent that the applicable conflict-of-laws rules provide that such priority rule governs. This issue is discussed in chapter X (see A/CN.9/WG.VI/WP.9/Add.7, paras. ...).

## **2. Priority rules**

6. This section discusses various possible approaches to determining priority. It is important to note that more than one of these rules may effectively coexist in the same legal system insofar as they may apply to different types of priority conflicts.

### **a. First-to-file priority rule**

7. As discussed above (see paras. 2-4), in order to effectively promote the availability of low-cost credit, consideration should be given to establishing priority rules that permit grantors to use the full value of their assets to obtain credit and creditors to determine their priority with the highest degree of certainty at the time they extend credit. As discussed in chapter V (see A/CN.9/WG.VI/WP.9/Add.2, paras. ...), one of the most effective ways to provide for such certainty, at least in the case of non-possessory security rights, is to base priority on the use of a public filing system.

8. In many jurisdictions in which there is a reliable filing system, priority is generally determined by the order of filing, with priority being accorded to the earliest filing (often referred to as the "first-to-file priority rule"). In some jurisdictions, this rule applies even if one or more of the requirements for the creation of a security right have not been satisfied at the time of the filing, which avoids the need for a creditor to search the filing system again after all remaining requirements for creation have been satisfied. This rule provides the creditor with certainty that once it files a notice of its security right, no other filing, except for the limited exceptions discussed in section A.3 below, will have priority over its security right. This certainty allows creditors to assess their priority position with a high degree of confidence, and as a result, reduces their credit risk. Other existing or potential creditors are also protected because the filing will put them on notice of the security right, or potential security right, and they can then take steps to protect themselves. Notwithstanding the foregoing, the first-to-file priority rule may not be customary in some cases, such as in the case of purchase money security rights, discussed in section A.3.c. below, or in the case of statutory (e.g. preferential) creditors, discussed in section A.3.f. below.

9. This first-to-file priority rule is illustrated in examples 2 and 3 (see A/CN.9/WG.VI/WP.6/Add.1, paras. 18 and 23). In these examples, Lender B and Lender C each have a security right in all of Agrico's existing and after-acquired inventory and receivables. Under a first-to-file priority rule, the lender who filed a notice of its security right in the inventory and receivables first would have priority over the other lender's security right, regardless of the time that all of the other requirements for the creation of each lender's security right have been satisfied.

10. Some jurisdictions provide that, as long as filing occurs within a certain "grace period" after the date on which the security right is created, priority will be based on the date of creation rather than on the date of filing. Thus, a security right that is created first, but filed second, may still have priority over a security right that is created second but filed first, as long as the first security right is filed within the applicable grace period. As a result, until the grace period expires, the filing date is not a reliable measure of a creditor's priority ranking, thus resulting in significant uncertainty. In legal systems in which no such grace periods exist, creditors are not at a disadvantage because they can always protect themselves by making a timely filing. Therefore, in order to avoid undermining the certainty achieved by the first-to-file rule, some jurisdictions restrict the use of grace periods to rare circumstances, applying only to specific situations such as (i) purchase money security rights in equipment (see paras. 21-29), (ii) circumstances in which filing before, or concurrently with, creation is not logistically possible, or (iii) where the time difference between creation and filing cannot be minimized through the use of electronic filing or other filing techniques.

11. The ordering of priority according to the timing of filing may apply even if the creditor acquired its security right with actual knowledge of an existing unfiled security right. Qualifications based on actual knowledge require a fact-specific investigation and subject filings to challenge, creating a new issue for litigation and an incentive to attack filings. All this diminishes certainty as to priority status and thereby reduces the efficiency and effectiveness of the system. As in the case of grace periods, there is no unfairness to secured creditors in this approach because they can always protect themselves by making a timely filing.

**b. Priority based on possession or control**

12. As discussed in chapters III and V (see A/CN.9/WG.VI/WP.6/Add.2, paras. 5-14, and A/CN.9/WG.VI/WP.9/Add.2, paras. ...), possessory security rights traditionally have been an important component of the secured lending laws of most jurisdictions. In recognition of this, even in certain jurisdictions that have a first-to-file priority rule, priority may also be established based on the date that the creditor obtained possession or control of the encumbered asset, without any requirement of a filing. In these systems, priority is often afforded to the creditor that first either filed a notice of its security right in the filing system or obtained a security right by possession or control.

13. In the case of certain types of encumbered assets, creditors often require possession or control to prevent prohibited dispositions by the grantor (i.e. instruments, such as certificated investment securities, or documents of title, such as bills of lading and warehouse receipts). For these types of assets, the priority of a security right therein may be established either by possession or control or by filing. A security right that becomes effective against third parties ("is perfected") by

possession or control has priority over a security right, perfected only by filing, even if the filing occurs first. In jurisdictions that have a filing system, except in rare circumstances such as this, alternative priority systems are not permitted to coexist with the first-to-file rule.

14. In legal systems where priority may be established either by filing, possession or control, a question arises as to whether a secured creditor who initially established priority by one method should be permitted to change to another method, without losing its original priority ranking with respect to the encumbered asset. In principle, there is nothing objectionable about permitting a creditor to retain its priority, provided there is no gap in the continuity of filing, possession or control, so that the security right is subject to one method or another at all times.

**c. Alternative priority rules**

15. In some legal systems, priority is based on the date that the security right is created as opposed to the date of filing (a different form of first-in-time rule). This approach has been adopted in some jurisdictions that permit non-possessory security rights but have not adopted a reliable filing system, or any filing system at all. In these jurisdictions, a creditor will typically confirm the existence or non-existence of competing claims through representations by the grantor or information available in the market.

16. In other legal systems, with respect to certain types of assets such as receivables, priority is based on the time that the debtors on the receivables (“the account debtors”) are notified of the existence of the security right. Like the system described in the immediately preceding and the immediately following paragraphs, this system also is not conducive to the promotion of low-cost secured credit because it does not permit the creditor to determine, with a sufficient degree of certainty at the time it extends credit, whether there are any competing security rights. However, in the case of security rights in receivables, even if notification of the account debtors is not a condition for the security right in receivables to be effective against third parties, notification may still be relevant with respect to other matters, such as discharge of the account debtor by payment to the right person or enforcement against the account debtor, even in jurisdictions that have adopted a filing system.

17. Retention of title arrangements are a primary example of security rights that are not subject to a filing requirement in most jurisdictions that recognize them and do not have a comprehensive security regime (i.e. a regime in which such rights are considered to be security rights subject to filing). In those jurisdictions, it is argued that this system is not only simple but also cost-efficient, because title retention arrangements generally are interest-free. However, the fact that such a system works in some countries does not necessarily mean that it can serve as a useful model. First, there is no single model since there are wide divergences among countries that follow this system (at least one country subjects retention of title arrangements to a filing system). Second, competition with other potential creditors is inhibited to the extent that such arrangements are available only to suppliers, as is the case in some countries. Third, even though such arrangements are often non-interest bearing, in the absence of competition credit could become more expensive, because even though not reflected in interest charges, the higher cost of credit could be built into the cost of the goods. Finally, although such systems may be extremely effective in



jurisdictions that possess a mature credit economy, it is generally accepted that the establishment of a first-in-time filing system is the most effective way to introduce a credit economy in a rapid way in a country that does not have one.

### **3. Types of competing claimants**

#### **a. Other consensual secured creditors**

18. As discussed above (see paras. 2-4), many legal systems allow the grantor to grant more than one security right in the same asset, basing the relative priority of such security rights on the priority rule (first-to-file or other rule) in effect under such system or on the agreement of the creditors (see paras. 76-77). Allowing multiple security rights in the same asset in this manner enables a grantor to use the value inherent in the asset to obtain credit from multiple sources, thereby unlocking the maximum borrowing potential of the asset.

#### **b. Unsecured creditors**

19. The grantor will often incur debts that are not secured by security rights. These general unsecured claims often comprise the bulk of the grantor's outstanding obligations.

20. While some question the fairness of giving secured creditors priority over unsecured creditors, it is well established that doing so is necessary to promote the availability of secured credit. Unsecured creditors can take steps to protect their interests, such as monitoring the status of the credit, requiring security in certain instances, charging interest on past due amounts or reducing their claims to judgements (as discussed in section A.3.e. below) in the event of non-payment. In addition, obtaining secured credit can increase the working capital of the grantor, which in many instances benefits the unsecured creditors by increasing the likelihood that the unsecured debt will be repaid. Thus, an essential element of an effective secured credit regime is that secured claims, properly obtained, have priority over general unsecured claims. Finally, in many legal systems, some classes of creditors who would otherwise be unsecured are given a special statutory priority (as discussed in section A.3.f. below).

#### **c. Sellers of encumbered assets**

##### **i. Purchase money security rights**

21. Typically, the grantor acquires its assets by purchasing them. If the purchase is made on credit provided by the seller or is financed by a lender ("purchase money financing"; see A/CN.9.WG.VI/WP.6/Add.1, paras. 16-18, and A/CN.9.WG.VI/WP.9/Add.1, paras. ...) and the seller or lender obtains a security right in the goods acquired to secure the purchase money financing, consideration must be given to the priority of such rights vis-à-vis security rights in the same goods held by other parties.

22. Recognizing that purchase money financing is an effective means of providing businesses with capital necessary to acquire specific goods, many legal systems provide that holders of purchase money security rights have priority over other creditors (including creditors that have an earlier-in-time filed security right in the goods) with respect to goods acquired with the proceeds of the purchase money financing, as long as a notice of the purchase money security right is filed within an

appropriate time (which may involve a “grace period” in the case of certain types of assets).

23. This heightened priority (sometimes referred to as a “super priority”) is a significant exception to the first-to-file priority rule discussed in section A.2.a. above that is important in promoting the availability of purchase money financing. As illustrated in examples 2 and 3 (see A/CN.9/WG.VI/WP.6/Add.1, paras. 23 and 26), businesses often grant security rights in all or some of their existing and after-acquired inventory and equipment to obtain financing. In these situations, if purchase money security rights were not afforded a heightened priority, purchase money financiers would not be able to place significant reliance on their security rights because they would rank behind existing security rights. In example 1 (see A/CN.9/WG.VI/WP.6/Add.1, paras. 18-20), vendor A, lender A and lessor A would each be reluctant to provide purchase money financing if their security rights in the goods financed ranked behind the existing security rights of lender B in example 2 and lender C in example 3.

24. Providing a heightened priority for purchase money security rights is generally not considered to be detrimental to the grantor’s other creditors, because purchase money financing does not diminish the estate (i.e. the net assets or net worth) of the grantor, but instead enriches the estate with new assets in return for the purchase money obligations. For example, the security positions of lenders B and C in examples 2 and 3 are not diminished by a purchase money financing, because the lenders still have all of their encumbered assets plus a security right subordinate to the purchase money security right in the new goods financed by the purchase money credit transaction.

25. In order to promote the availability of purchase money financing without discouraging general secured credit, it is important that the heightened priority afforded to purchase money security rights only apply to the goods acquired with such purchase money and not to any other assets of the grantor.

26. In some legal systems, purchase money security rights are not subject to filing (on the theory, *inter alia*, that vendors of goods may be unsophisticated parties who should not be expected to file or search in the register). However, in other legal systems, purchase money security rights are subject to filing in order to avoid other creditors mistakenly relying on assets subject to purchase money security rights (see A/CN.9/WG.VI/WP.9/Add.2, paras. ...).

27. From the perspective of a competing creditor, it would be beneficial if a notice of such security rights was required to be filed at the time the rights were obtained. This would mean that any creditor could search the filing system and determine with certainty, at the time of the search, whether any of the grantor’s existing assets are subject to purchase money security rights. However, in order to facilitate on-the-spot financing in the equipment sales and leasing sectors, some systems provide a grace period for purchase money filings where the encumbered assets consist of equipment. To most effectively balance competing interests, this grace period must be long enough so that the filing requirement is not an undue burden to purchase money financiers, but short enough so that other secured creditors are not subject to long periods before they are able to search the registry and determine if any competing security rights exist.

28. Typically, such a grace period does not apply to filings with respect to purchase money security interests in inventory. Instead, in order to obtain a super priority in inventory, in some legal systems the holder of such a security right must, in addition to filing, give notice of the security right to other existing holders of security rights. The argument in favour of requiring such notice is that existing inventory financiers should be put on notice of the purchase money rights so that they will not make additional loans against the debtor's existing inventory in the mistaken belief that they would have a first priority in such inventory. To otherwise eliminate this danger, they would need to check the register daily before each new advance against inventory to assure that there were no claimed purchase money rights in the inventory (a circumstance that could significantly increase the cost of such financing), and even checking daily would not suffice if a grace period were afforded to the purchase money security rights.

29. An important policy decision that must be made in fashioning a super priority for purchase money financing is whether such a priority should be available only to sellers of goods, or whether it should also extend to banks and other lenders who finance the acquisition of goods. The arguments in favour of limiting the priority to vendors tend to be historical, in that supplier-financing (e.g. in the form of retention of title arrangements) was developed as a low-cost and efficient alternative to bank financing. A principal argument in favour of extending the priority to banks and other lenders is that such equal treatment enhances competition, which in turn should have a positive impact upon both the availability and the cost of credit.

## ii. Reclamation claims

30. In many legal systems, a supplier who sells goods on unsecured credit may reclaim the goods from the buyer within a specified period of time (known as the "reclamation period"). This reclamation is possible after the supplier discovers that the buyer has become the subject of an insolvency proceeding or is otherwise insolvent. Upon the return of the goods to the seller, the sales agreement under which the goods were originally sold to the buyer generally is deemed terminated.

31. Although the supplier will want the reclamation period to be as long as possible to protect its interests, other creditors will be reluctant to provide credit based on assets subject to potential reclamation claims. Moreover, if the supplier is truly concerned about the credit risk, the supplier could insist upon a purchase money security right in the goods that it supplies on credit. Accordingly, although a reclamation claim is important so that suppliers can have some rights in the goods that they supply on unsecured credit, the reclamation period should be brief (30-45 days at most) so that it does not impede lending generally.

32. An important policy consideration is whether reclamation claims relating to specific goods should have priority over pre-existing security rights in the same goods. In other words, the question is whether, if the inventory of the buyer, including the goods sought to be reclaimed, is subject to effective security rights in favour of a third party financier, the reclaimed goods should be returned to the seller free of such security rights. In some jurisdictions, the reclamation has a retroactive effect, placing the seller in the same position it was prior to the sale (i.e. holding goods that were not subject to any security rights in favour of the buyer's creditors). However, in other jurisdictions the goods remain subject to the pre-existing security rights, on the theory that any other result would be unfair to a pre-existing creditor

of the buyer who had relied on the existence of such goods in extending credit, and would also promote uncertainty and thereby discourage inventory financing.

33. In many jurisdictions, reclamation claims in specific goods are extinguished at such time as the goods are incorporated into other goods in the manufacturing process or otherwise lose their identity.

**d. Buyers of encumbered assets**

34. The grantor may also sell assets that are subject to existing security rights. In this situation the buyer has an interest in receiving the assets free and clear of any security right, whereas the existing secured creditor has an interest in maintaining its security right in the assets sold. It is important that a priority rule addresses both of these interests, and that an appropriate balance be struck. If the rights of a secured creditor are jeopardized every time its grantor sells the encumbered assets, the value of such assets as security would be severely diminished, and the availability of low-cost credit based on the value of such assets would be impeded.

35. It is sometimes argued that the secured creditor is not harmed by a sale of the assets free of the security right so long as the secured party retains a security right in the proceeds of the sale. However, this would not necessarily protect the secured creditor, because proceeds often are not as valuable to the creditor as the original encumbered assets. In many instances, the proceeds may have little or no value to the creditor as security (e.g. a receivable that cannot be collected). In other instances, it might be difficult for the creditor to identify the proceeds, and its claim to the proceeds may, therefore, be illusory. Also, there is a risk that the proceeds, even if of value to the secured creditor, may be dissipated by the seller who receives them, leaving the creditor with nothing.

**i. The ordinary course of business approach**

36. Jurisdictions have taken a number of different approaches to achieving this balance between the interests of secured creditors and persons buying encumbered assets from grantors in possession. One approach taken in many jurisdictions is to provide that sales of encumbered assets in the form of inventory, made by the grantor in the ordinary course of its business will result in the extinction of any security rights that the secured creditor has in the assets, automatically and without any further action on the part of the buyer, seller or secured creditor. The corollary to this rule is that sales of inventory outside the ordinary course of the grantor's business will not extinguish any security rights, and the secured creditor may, upon a default by the grantor, enforce its security right against the inventory in the hands of the buyer (unless, of course, the secured creditor has consented to the sale).

37. This approach arguably provides a simple and transparent basis for determining whether goods are sold free and clear of security rights. For example, in the case of an automobile dealership, a sale of an automobile by an automobile dealer to a consumer is clearly a sale of inventory in the ordinary course of the dealer's business, and the consumer should automatically take the car free and clear of any security rights in favour of the dealer's creditors. On the other hand, a sale by the dealer of many cars in bulk to another dealer would presumably not be in the ordinary course of the dealer's business. This approach is consistent with the commercial expectation that the grantor will sell its inventory of goods (and indeed

must sell it to remain viable), and that buyers of the goods will take them free and clear of existing security rights. Without such an exemption, a grantor's ability to sell goods in the ordinary course of its business would be greatly impeded, because buyers would have to investigate claims to the goods prior to purchasing them. This would result in significant transaction costs and would greatly impede ordinary course transactions.

38. To promote such ordinary course transfers, many legal systems provide that buyers in such transactions obtain the assets free and clear of any security right even if the buyer had actual knowledge of the security right. This exception, however, is limited in some jurisdictions if the buyer had knowledge that the sale was made in violation of an agreement between the seller and its creditor that the assets would not be sold without the consent of the creditor.

39. With respect to sales that are outside of the ordinary course of the grantor's business, as long as the creditor's security right is subject to filing in a reliable and easily accessible filing system, the buyer may protect itself by searching the filing system to determine whether the asset it is purchasing is subject to a security right, and if so, seek a release of the security right from the secured creditor. Consideration might be given to whether any low-cost items should be exempted from this rule because the search costs imposed on potential buyers may not be justified for such items. On the other hand, it may be argued that, if an item is truly low-cost, a secured creditor is unlikely to enforce its security right against the asset in the hands of the buyer. In addition, determining which items are sufficiently low-cost to be so exempted would result in arbitrary linedrawing and would have to be continually revised to respond to cost fluctuations resulting from inflation and other factors. As a result, it may be best not to provide for such an exemption.

40. In some countries that have a filing system that is searchable only by the grantor's name, rather than by a description of the encumbered assets, a purchaser who purchases the assets from a seller who previously purchased the assets from the grantor ("remote purchasers") obtains the assets free of the security rights granted by such grantor. This approach is taken because it would be difficult for a remote purchaser to detect the existence of a security right granted by a previous owner of the encumbered assets. In many instances, remote purchasers are not aware that the previous owner ever owned the asset, and accordingly, have no reason to conduct a search against the previous owner.

41. A possible disadvantage of the ordinary course of business approach is that it might not always be clear to a buyer (particularly in international trade) what activities might be within or not within the ordinary course of the seller's business. Another possible disadvantage might be that, if this rule were applied only to sales of inventory and not of other goods, there could be confusion on the part of the buyer as to whether the goods it is buying constitute inventory from the seller's point of view. On the other hand, it should be noted that, in a normal buyer-seller relationship, it is highly likely that buyers would know the type of business in which the seller is involved. In addition, this approach effectively addresses a need of practice without undermining secured credit or creating unnecessary complications. Moreover, these possible disadvantages would not apply to retail trade (where the sale is presumed to be in the ordinary course of the seller's business, and a buyer is not required to check the registry), while in other situations buyers could protect

themselves by negotiating with sellers (and their secured creditors) to obtain the assets free of any security rights.

**ii. The good faith approach**

42. Another approach to this problem taken by some jurisdictions is to provide that a buyer of goods will take free of any security rights in the goods if the buyer purchases the goods “in good faith” (i.e. with no actual or constructive knowledge of the existence of the security rights). One argument in favour of this approach is that “good faith” is a notion known to all legal systems, and that there exists significant experience with its application both at the national and international level. It has also been argued that a presumption should exist that a buyer is acting in good faith unless it is proven otherwise.

43. A number of approaches are possible that seek to blend the “good faith” and the “ordinary course of business” approaches. One such approach is to provide that the principal criterion should be the “ordinary course of business” test, but that the “good faith” test should be applied in the situation of the “remote purchaser” described above (see para. 40). In that case, the remote purchaser would take free of security rights created by the party from whom its direct seller purchased the goods, unless the remote purchaser had actual or constructive knowledge of the security rights. Even though this approach might inadvertently open the way to abuse, since a grantor could frustrate the rights of the secured creditor by selling the goods outside the ordinary course of business to a party who would then sell them in the ordinary course of business, there is a strong policy reason to protect remote purchasers. One approach to protect secured creditors in this circumstance is to make the circumventing grantor liable to the secured creditor for damages.

**e. Judgement creditors**

44. In many legal systems, a security right is extended to certain classes of creditors felt to be deserving of such a right. For example, many legal systems provide that, once general unsecured creditors have reduced their claims to judgement and have taken certain action prescribed by law (such as seizing specific property or registering the judgement), such creditors are given the equivalent of a security right in that property.

45. Judgement creditors are given priority over other unsecured creditors in recognition of the legal steps they have taken to enforce their claims. This is not unfair to other general unsecured creditors because they have the same rights to reduce their claims to judgement. To avoid giving judgement creditors excessive powers in legal systems where a single creditor may institute insolvency proceedings, insolvency laws provide that security rights arising from judgements made within a specified period of time prior to the insolvency proceeding may be avoided by the insolvency representative.

46. Where a judgement creditor is given the equivalent of a security right, an existing creditor with an earlier-in-time consensual security right in certain assets has an interest in making sure that its security right retains its priority over the security right obtained by a judgement, particularly with respect to assets it has already relied upon in extending credit. On the other hand, the judgement creditor

has an interest in receiving priority with respect to assets that have sufficient value to serve as a source of repayment of its claim.

47. Many legal systems that have a filing system rank priority in this situation by time of filing of the security right, i.e. an earlier in time filed consensual security right in property will have priority over a subsequent security right in the same property obtained by judgement. Conversely, any attempt to grant a consensual security right in the property after a creditor has obtained some form of a judgement security right will result in an interest that is subordinate to the existing judgement security right. This approach is generally acceptable to creditors as long as the judgement security right is made sufficiently public so that creditors can become aware of it in an efficient manner and factor its existence into their credit decision before extending credit (see para. 48).

48. There is generally an exception to this rule when it is applied to future advances (discussed in greater detail in section A.4.a. below). While a previously filed security right customarily will have priority over a judgement security right with respect to credit advanced prior to the date that the judgement security right becomes effective, it will generally not have priority over the judgement security right with respect to any credit advanced after such effective date (unless such credit had been committed prior to the effective date of the judgement). For example, in example 2 (see A/CN.9/WG.VI/WP.6/Add.1, para. 23, lender B makes loans from time to time to Agrico, which are secured by all of Agrico's receivables and inventory. If an unsecured creditor reduces its claim to a judgement against Agrico and thereby obtains a security right in Agrico's inventory, lender B's security right in the inventory would have priority over the judgement security right with respect to loans that lender B made prior to the date that the judgement became effective, as well as loans that lender B made within a specified period following the effective date of the judgement. However, the judgement security right would have priority with respect to any additional loans made by lender B after the specified period (as long as lender B did not commit prior to the effective date of the judgement to extend such additional loans).

49. To protect existing secured creditors from making additional advances based on the value of assets subject to judgement security rights, there should be some mechanism to put creditors on notice of such judgement security rights. In many jurisdictions in which there is a filing system, this notice is provided by subjecting judgement security rights to the filing system. If there is no filing system or if judgement security rights are not subject to the filing system, the judgement creditor might be required to notify the existing secured creditors. In addition, it may be provided that the existing secured creditor's priority continues for a period of time (perhaps 45-60 days) after the judgement security right is filed (or after the creditor receives notice) so that the creditor can take steps to protect its interest accordingly. The less time an existing secured creditor has to react to the existence of judgement security rights and the less public such judgement security rights are made, the more their potential existence will impede the availability of credit facilities that provide for future advances.

**f. Statutory (preferential) creditors**

50. In many jurisdictions, as a means of achieving a general societal goal (e.g. protection of tax revenue or employee wages), certain unsecured claims are given

priority (in insolvency proceedings or even outside insolvency proceedings) over other unsecured claims, and in some cases, over secured claims (including secured claims previously filed). For example, to protect claims of employees and the Government, claims for unpaid wages and unpaid taxes are given, in some jurisdictions, priority over previously existing security rights. Because societal goals differ from jurisdiction to jurisdiction, the types of these claims, and the extent to which they are afforded priority, also differ.

51. The advantage of establishing these preferential claims is that a societal goal may be furthered. The possible disadvantage is that these types of priorities can proliferate in a fashion that reduces certainty among existing and potential creditors, thereby impeding the availability of low-cost secured credit. In addition, even if the preferential claims can be ascertained with certainty by an existing or potential creditor, such claims (whether arising within or outside of insolvency proceedings) will adversely affect the availability of secured credit in another way: creditors will often shift the economic burden of such claims to the grantor by increasing the interest rate, or by withholding the estimated amount of such claims from the available credit.

52. To avoid discouraging secured credit, the availability of which is also a societal goal, the various societal goals should be carefully weighed in deciding whether to provide a preferential claim. Preferential claims should be as limited as possible, permitted only to the extent that there is no other effective means of satisfying the underlying societal goal and the impact on the availability of low-cost credit is acceptable. For example, in some jurisdictions, tax revenue is protected through incentives on company directors to address financial problems quickly or face personal liability, while wage claims are protected through a public fund.

53. If preferential claims exist, the laws establishing them should be sufficiently clear and transparent so that a creditor is able to calculate the potential amount of the preferential claims and to protect itself. Some jurisdictions have achieved such clarity and transparency by listing all preferential claims in one law or in an annex to the law. Other jurisdictions have achieved it by requiring that preferential claims be filed in a public registry, and according priority to such claims only over security rights filed thereafter. In those jurisdictions, security rights that were either filed before the preferential claims are filed, or within a specified period, such as 45-60 days, after the preferential claims are filed are given priority, if the pre-existing security rights secure a commitment to provide future advances. However, a problem with adopting a filing requirement with respect to some preferential claims that arise immediately prior to an insolvency proceeding is that it may be difficult to calculate their amount or to file in time.

**g. Creditors adding value to or storing encumbered assets**

54. Some legal systems provide that creditors who improve or fix encumbered assets, such as equipment repairers, have security rights in the encumbered assets they improve or fix, and that such security rights generally rank ahead of other secured claims in the encumbered assets. This priority rule has the advantage of inducing those who supply such value to continue in their efforts, and also has the advantage of facilitating the maintenance of the encumbered assets. As long as the amount that these security rights secure is limited to an amount that reflects the



value by which the encumbered asset has been enhanced, such security rights and their elevated priority should be unobjectionable to existing secured creditors.

55. Some systems also provide that creditors, such as landlords and warehousemen, who store encumbered assets or who lease to a grantor the premises on which the encumbered assets are stored, have security rights in the encumbered assets to secure the rental and storage obligations, and such security rights often rank ahead of other secured claims in the same encumbered assets.

56. In many jurisdictions, the rights described in the preceding two paragraphs are not subject to any filing requirement, and their existence can only be discerned through due diligence on the part of a prospective creditor. As a result, these security rights are often referred to as being “secret”. While secret security rights have the advantage of protecting the rights of the parties to whom they are granted without requiring such parties to incur the costs associated with filing, they pose a significant impediment to secured credit because they limit the ability of creditors to determine competing security rights. As discussed in chapter V (see A/CN.9/WG.VI/WP.9/Add.2, paras. ...), consideration should be given to requiring that notice of such security rights be filed in the security rights filing system.

57. If legislators give priority to the rights of such service providers, a question arises as to whether these rights should be limited in amount and recognized as priority claims subject to certain conditions. One approach may be to limit these rights in favour of service providers in amount (such as one month’s rent in the case of landlords) and to recognize their priority over pre-existing security rights only where the value added directly benefits the holders of the pre-existing security rights. Another approach may be to avoid introducing such limitations since doing so would unfairly inhibit the availability of credit to such service providers. In addition, introducing such limitations may be unnecessary since secured creditors can protect themselves against such service claims in various ways, such as by contractually limiting the extent to which their grantors may enter into such service contracts, or by reserving a sufficient portion of the available credit to enable the creditor to pay the service providers in the event that the grantor fails to do so.

#### **h. Insolvency representatives**

58. It is particularly important that a secured creditor be able to determine what its priority will be in the event that an insolvency proceeding is commenced by or against its grantor, because there most likely will not be sufficient assets to pay all creditors and the encumbered assets may be its primary, or only, source of repayment. As a result, in deciding to extend credit and in evaluating priority, secured creditors generally place their greatest focus on what their priority will be in an insolvency proceeding of the grantor. Therefore, it is important that the priority of a properly obtained security right not be diminished or impaired in an insolvency proceeding. The importance of this point in crafting an effective secured transactions law cannot be over-emphasized. To the extent that secured credit and insolvency laws are not clear on this point, the willingness of creditors to provide secured credit will be seriously diminished.

59. In order to effectively compensate insolvency representatives for their work in the insolvency proceeding, they often are given a super priority preferential claim in the assets of the insolvent estate. This claim and the extent to which an insolvency

representative may be empowered to challenge security rights in various circumstances are discussed in detail in chapter IX (A/CN.9/WG.VI/WP.9/Add.6, paras. ...).

#### **4. Priority in future advances and after-acquired property**

##### **a. Future advances**

60. In order to determine the amount of credit to be extended and the relevant terms, a secured creditor needs to be able to determine, at the time of the conclusion of the secured transaction, how much of its claim will be accorded priority. Some legal systems limit this priority to the amount of debt existing at the time of the creation of the security right. Other legal systems require publicity of the maximum amount of credit that will be extended priority. Yet other legal systems accord priority for all extensions of credit, even those made after the creation of the security right.

61. The advantage of limiting priority to the amount of debt originally in existence at the time that the security right was created is that it may (though not necessarily) match priority with the contemplation of the parties at the time of creation, and preserves only that priority against creditors then in existence. The disadvantage of this approach is that it requires additional due diligence (e.g. searches for new filings), and additional agreements and filings for amounts subsequently advanced. This is particularly problematic because one of the most effective means of providing secured credit is on a revolving basis, since this type of credit facility most efficiently matches the grantor's particular borrowing needs (see example 2 in A/CN.9/WG.VI/WP.6/Add.1, paras. 21-23, and Add.3, para. 9). Accordingly, future advances may be given the same priority afforded to advances made at the time that the security right is first created. In the case of credit extended in the context of contracts for the delivery of goods or services in instalments, the entire claim should be considered to have come into existence when the contract is signed, and not upon each delivery of goods or services.

62. To avoid tying up all the grantor's assets with one creditor, thus reducing the willingness with which subsequent creditors may extend credit to the grantor, many legal systems require that security right filings set forth a maximum amount of debt that may be secured by any given security right, and limit priority to such maximum amount (see A/CN.9/WG.VI/WP.9/Add.2, paras. ...). It is sometimes argued that disclosing a maximum amount may raise an issue of confidentiality. However, the contrary argument is that the maximum amount in the filed notice does not necessarily reflect the actual amount of the secured obligation, but only the maximum amount that may be recovered in the event the security right is enforced.

##### **b. After-acquired property**

63. As discussed in greater detail in chapter IV (see A/CN.9/WG.VI/WP.6/Add.3, paras. 19-23), in some legal systems a security right may be created in property that the grantor may acquire in the future. Such a security right is obtained simultaneously with the grantor's acquisition of the property, without any additional steps being required each time additional property is acquired. As a result, the costs incident to the grant of a security right are minimized and the expectations of the parties are met. This is particularly important with respect to inventory (which is acquired for resale), receivables (which are collected and regenerated on a continual

basis) (see example 2 in A/CN.9/WG.VI/WP.6/Add.1, paras. 21-23) and equipment (which is replaced in the normal course of the grantor's business).

64. The allowance of security rights in after-acquired property raises the question of whether the priority dates from the time of the initial grant or from the time the grantor acquires the property. Different legal systems address this matter in different ways. Some legal systems vary the effect depending on the status of the creditor competing for priority (with priority dating from the date of the grant vis-à-vis other consensual security creditors, and from the date of acquisition vis-à-vis all other creditors). It is generally accepted that dating priority from the initial grant, rather than from the date the grantor acquires rights in the encumbered assets, is the most efficient and effective approach in terms of promoting the availability of low-cost secured credit (see, for example, article 8 (2) of the United Nations Assignment Convention).

## 5. Priority in proceeds

65. If the creditor has a right in proceeds and civil fruits of the original encumbered asset, issues will arise as to the status and priority of that right as against other competing claimants. Competing claimants with respect to proceeds may include a creditor of the grantor who has obtained a right by judgement or execution against the proceeds and another creditor who has a security right in the proceeds as original encumbered assets, as well as other competing claimants of the types mentioned above (as to what constitutes proceeds, see A/CN.9/WG.VI/WP.6/Add.3, paras. 36-40).

66. A secured creditor may have a security right in proceeds as original encumbered assets or as after-acquired proceeds of other encumbered assets. For example, assume that creditor A has a security right in all of the grantor's inventory and creditor B has a security right in all of the grantor's receivables (including future receivables). Assume further that the grantor debtor later sells on credit inventory that is subject to the security interest of creditor A. Both creditors have a security right in the receivable generated by the sale. Creditor B has a right in the receivable as an original encumbered asset and creditor A has a security right in the receivable as proceeds of the encumbered inventory.

67. A comprehensive legal system governing security rights must answer several questions with respect to competing claims of the above-mentioned secured creditors. One question is whether the right of creditor A in the receivable as proceeds of inventory is effective not only against the grantor but also against competing claimants. The answer to this question must be affirmative, in most circumstances. Otherwise, the value of the original encumbered assets (e.g. the inventory) would be largely illusory. Security rights add economic security (thereby increasing access to credit at lower cost) only in cases in which the security right provides the creditor with the right to apply the economic value of the encumbered asset to the debt owed to the creditor before that value is applied to claims of other claimants.

68. Nonetheless, it must be recognized that the creation of a right in proceeds raises important concerns about the risks created for third parties. In particular, considerations that lead to a requirement of publicity for a security right in

particular property to be effective against third parties may suggest that similar requirements are appropriate for the right in proceeds.

69. Therefore, a legal regime should contain rules that determine when the publicity that is given to the security right in the original encumbered asset will suffice to publicize the creditor's right in the proceeds. In cases in which a different mode of publicity (e.g. notification of an account debtor instead of filing) is required for the creditor's right in the proceeds, the legal regime should provide a period of time after the transaction generating the proceeds in which the creditor may provide the publicity without losing its right in the proceeds.

70. While determination of whether a new act of publicity is necessary in order for the creditor's right in proceeds to be effective against third parties is quite important, that determination alone is not sufficient to resolve the relative rights of the secured creditor and other creditors in proceeds. In particular, priority rules are needed to determine the relative priority of the secured creditor's right.

71. The priority rules may differ depending on the nature of the competing claimant. For example, if the competing claimant is another secured creditor whose rights are also dependent on publicity, the rules determining the relative priority of the rights of the two secured creditors might depend on the nature and timing of the publicity. Priority may depend on other factors when the competing claimant is a judgement creditor or an insolvency administrator.

72. In many cases in which the competing claimant is another secured party, the priority rules for rights in proceeds of original encumbered assets may be derived from the priority rules applicable to the original encumbered asset and the policies that generated those rules. For example, in a legal system in which the first right in particular property that is publicized has priority over competing rights, that same rule could be used to determine the priority when the original encumbered asset has been transferred and the secured creditor now claims a right in proceeds. If the right in the original encumbered asset was publicized before the right of the competing claimant in the proceeds was publicized, that right could be given priority.

73. In cases in which the order of priority of competing rights in the original encumbered asset is not determined by the order of publicity (as is the case, for example, with purchase money security rights that enjoy a super priority) a separate determination will be necessary for the priority rule that would apply to the proceeds of the original encumbered asset.

## **6. Voluntary alteration of priority: subordination agreements**

74. In many legal systems, priority may be, and frequently is, altered by a secured creditor unilaterally or by private contract with other secured creditors. As an example, a lender with a security right in all existing and after-acquired assets of a grantor could agree that the grantor might give a first priority security right in a particular asset so that the grantor could obtain additional financing from a source other than the lender based on the value of that asset. Such agreements are to be distinguished from subordination agreements between unsecured creditors waiving the principle of equal treatment of their unsecured claims. The recognition of the validity of subordination of security rights unilaterally or by private contract reflects a well-established policy (see, for example, article 25 of the United Nations Assignment Convention).

75. Such agreements altering priority are perfectly acceptable as long as they affect only the parties who actually consent to such alterations. Subordination agreements should not affect the rights of creditors who are not parties to the agreement. Additionally, it is essential that the priority afforded by a subordination agreement continue to apply in an insolvency proceeding of the grantor, and the insolvency laws should so provide. In fact, in some jurisdictions, such a provision in the insolvency laws may be necessary to empower the courts to enforce subordination agreements, and to empower insolvency representatives to deal with priority conflicts among parties to subordination agreements without risk of liability (see A/CN.9/WG.VI/WP.9/Add.6, paras. ...).

#### **7. Relevance of priority prior to enforcement**

76. Another important issue pertaining to priority is whether priority only has relevance after the occurrence of a default by the grantor in the underlying obligation or whether priority also has relevance prior to default. Many jurisdictions adopt the former approach, thereby allowing the holder of a subordinate consensual security right to receive a regularly scheduled payment on its obligation even though the secured obligation having priority has not been paid in full, absent a contrary agreement between the first-ranking and subordinate claimants. The theory for this approach is that, absent a contrary agreement and prior to a default, a grantor should be free to dispose of its assets and use the proceeds to pay its obligations as they mature, irrespective of the relative priority of the security rights in such assets. Requiring the subordinate claimant to remit the payment absent such an express agreement would be a major impediment to the subordinate claimant providing financing.

77. The result may be different if the subordinate claimant received proceeds from the collection, sale or other disposition of the encumbered asset. In that circumstance, some jurisdictions require the subordinate claimant to remit the proceeds to the first-ranking claimant if the subordinate claimant received the proceeds with the knowledge that the grantor was required to remit them to the first-ranking claimant. The rationale behind this rule is similar to the rationale discussed in section A.3.d. above with respect to buyers of encumbered assets.

### **B. Summary and recommendations**

78. The concept of priority is a critical component in any secured transactions regime that seeks to promote the availability of low-cost secured credit. The availability of credit is dependent on the ability of creditors to determine, with a high degree of certainty prior to extending credit, what their priority will be if they attempted to realize on their security. Because such realization often occurs in an insolvency proceeding of the grantor, it is critical that a secured creditor's priority continue unimpaired in the insolvency proceeding (see A/CN.9/WG.VI/WP.9/Add.6, para. ...).

79. It is, therefore, important that secured transactions laws include priority rules that are clear and workable leading to predictable outcomes. These rules should allow all creditors, even unsecured creditors, to assess their positions in advance of extending credit and to take steps to protect their interests. Clear priority rules that

result in predictable outcomes and efficient mechanisms for ascertaining and establishing priority at the time credit is advanced are as important to creditors as the particulars of the priority rule itself.

80. This result may be achieved most effectively by establishing a filing system and according priority to the first to file a notice of a security right. In addition, assuming that the filing system is reliable and easily accessible, it may provide an effective mechanism for alerting creditors to competing security rights (see paras. 7-9).

81. An essential element of an effective secured transactions regime is that secured claims, properly obtained, should have priority over general unsecured claims.

82. If possessory security rights are to remain a component of a security regime, they must be taken into account in crafting a priority rule. Thus, it may be appropriate to provide that the priority of a security right may be established either by possession or control or by filing, whichever occurs first. In such situations, it is also appropriate to permit a secured creditor who initially established priority by one method to change to another method, without losing its original priority ranking with respect to the encumbered asset, provided there is no gap in the continuity of filing, possession or control, so that the security right is subject to one method or another at all times. Moreover, in the case of certain types of assets, it may be appropriate to provide that a security right perfected by possession or control has priority over a security right that is perfected only by filing, even if the filing occurs first (see paras. 12-14).

83. Exceptions to the first-to-file priority rule should only be considered to the extent that there is no other means to satisfy the underlying policy objective of the exception and that objective justifies the impact of the exception on the availability of low-cost credit. Any such exceptions should be stated clearly, allowing creditors to assess the likelihood of any preferential claims and to take steps to protect themselves with respect to such claims. In order to most effectively alert creditors as to competing claims, consideration should be given to subjecting all claims, including preferential claims, to the security right filing system (see paras. 50-53). Some important exceptions to the first-to-file priority rule that should be addressed in crafting secured transactions laws pertain to purchase money security rights, and creditors that add value to encumbered assets (such as equipment repairers; see paras. 54-57).

84. Because purchase money financing is an effective means of providing businesses with capital necessary to acquire specific goods, an effective secured transaction regime should provide that holders of purchase money security rights have priority over other creditors (including creditors that have an earlier-in-time filed security right in the goods) with respect to goods acquired with the proceeds of the purchase money financing. With respect to transactions relating to inventory, in addition to filing, appropriate notice of the purchase money security right should be given to other creditors on record. In addition to vendors of goods, this heightened priority should be extended to banks and other lenders who finance the acquisition of goods (see paras. 21-29).

85. An effective secured transaction regime should strike an appropriate balance between the rights of buyers of goods and secured creditors holding security rights

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in such goods. Such a balance should include a provision that buyers of inventory sold in the ordinary course of the grantor's business should take free of any security rights in the goods granted by the seller, and the secured creditor should receive a security right in the proceeds of sale (see paras. 34-43).

86. Recognizing priority with respect to future advances and after-acquired property is likely to encourage the availability of revolving and other similar credits to businesses. The simpler the procedure that a creditor must comply with in order to establish priority with respect to future advances and after-acquired property, the greater will be the availability of these forms of credit (see paras. 60-63).

87. To avoid hindering the advancement of revolving credits as discussed above (see paras. 47 and 60) or any other similar form of credit, the amount to which future advances are afforded priority should not be limited.

88. At least in certain circumstances, the right of the secured creditor in the proceeds of its encumbered assets should be effective not only as against the grantor but also as against competing claimants. A legal regime should provide when a publicity act with respect to the security right suffices to publicize the creditor's rights in the proceeds or when a new publicity act is required. In addition, a legal regime should include priority rules with respect to rights in proceeds. Such rules may differ depending on the nature of the competing claimant (see paras. 65-73).

89. Regardless of the priority rules of any secured transactions regime, creditors should be permitted to vary such rules by private contract in order to structure financing arrangements that best suit the grantor's needs. Such agreements should be recognized as effective among the parties thereto in the grantor's insolvency proceeding. However, they should not affect the rights of persons who are not parties to such agreements (see paras. 74-75).

90. Finally, secured transactions regimes should specify the circumstances in which the holders of subordinate security rights in specific encumbered assets will, prior to default and enforcement, be prevented from taking actions that are inconsistent with the rights of the holders of first-ranking security rights in the same assets. Examples of such actions include retaining proceeds from the sale or other disposition of such assets with knowledge of the grantor's contractual obligation to remit those proceeds to the first-ranking secured creditor (see paras. 76-77).

**Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fourth session**

ADDENDUM

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## VII. Pre-default rights and obligations of the parties

### A. General remarks

#### 1. Introduction

1. The requirements for a valid and enforceable security agreement should be minimal and easy to satisfy (see A/CN.9/WG.VI/WP.9/Add.1, paras. ...). However, efficiency and predictability in secured transactions call for additional terms in the security agreement aimed at covering other aspects of the transaction. The parties themselves are encouraged to tailor the terms of the security agreement to fit their



own needs and wishes. However, to fill gaps that may arise if the parties do not include additional terms, a modern secured transactions regime should include a set of suppletive rules detailing the parties' rights and obligations before default. An example of such a rule may be a rule that provides that revenues deriving from the encumbered assets may be retained by the secured creditor and increase the value of the encumbered asset or may be applied to the payment of the secured obligation in the case of default.

2. Comprehensive coverage in a secured transactions regime of the rights and obligations of the parties before default increase efficiency and predictability in several ways. It helps clarify the position of the parties by filling potential gaps with respect to issues not addressed by parties in the security agreement. Permitting the parties to define their relationship with the assistance of a set of suppletive rules also constitutes a core principle for an effective regime of secured transactions in personal property, or at least one of its most important corollaries (see A/CN.9/WG.VI/WP.6/Add.1, paras. 28 and 30). In this regard, the Guide pursues a policy shared by modern national legal systems (e.g. articles 2736-2742 of the Quebec Civil Code and article 9-207 to 9-210 of the Uniform Commercial Code), regional model laws (e.g. article 15 of the EBRD Model Law and article 33 of the Inter-American Model Law), and international conventions dealing with international sales (i.e. article 6 of the CISG) or some aspect of secured transactions in movable assets (e.g. article 11.1 of the United Nations Assignment Convention and article 16 of the Mobile Equipment Convention).

3. In addition, by allocating rights and obligations between secured creditor and grantor in the manner they themselves were most likely to agree, a set of suppletive norms helps to reduce transaction costs, eliminating the need for the parties to negotiate and draft new provisions already adequately covered by the rules. Also, clear suppletive rules provide direction to the parties and courts or arbitral tribunals, reducing potential disputes, related costs and inconsistent judgements. Finally, by offering a series of rules from which the parties may opt out, suppletive rules may be used as a drafting aid, providing a checklist of issues the parties may wish to address at the time of negotiation and conclusion of the security agreement.

4. Moreover, suppletive rules make it possible for the principle of party autonomy to operate to the full benefit of the parties. This is particularly important in long-term transactions or other transactions where the parties cannot anticipate everything or even have an interest in following a flexible approach, since requiring the parties to formalize all subsequent modifications and additions to their initial agreement would impose significant compliance costs, which would ultimately be borne by the grantor.

5. There are three limitations to the scope of this Chapter. First, it does not deal with the terms required for a security right to exist (e.g. the minimum contents of the security agreement), since they fulfil a different function and are, therefore, addressed in Chapter IV (see A/CN.9/WG.VI/WP.6/Add.3, paras. 48-60). Second, this Chapter does not deal with the rights and obligations of the parties arising after default, since after default different policy issues arise that are addressed in Chapter VIII (see A/CN.9/WG.VI/WP.9/Add.5). And third, this Chapter is not intended to provide an exhaustive list of issues the parties may wish to address at the time they enter into contract negotiations, but offers, by necessity, only an

indicative or non-exhaustive list of rights and obligations on which the parties freely negotiating a typical secured transaction are most likely to agree.

6. The initial discussion below is focused on two important policy issues. The first relates to the principle of party autonomy and the extent to which the parties should be free to fashion the terms of their security agreement (assuming that the agreement satisfies the substantive and formal requirements for the creation of a security right). The second relates to the type and number of suppletive rules to be included in modern secured transactions legislation, so as to encompass new and evolving forms of secured transactions. This Chapter concludes by outlining recommended suppletive rules.

## **2. Party autonomy**

### **a. The principle**

7. To the extent that consumer-protection or similar public policy considerations are not interfered with, party autonomy may be established as a cardinal principle governing the relationship of the parties to the security agreement prior to default. While party autonomy gives credit providers significant power in determining the content of the security agreement, it also results in providing grantors with wider access to credit at a lower cost.

### **b. Limitations**

8. The secured creditor and the grantor should be mostly free to deal with their mutual contractual rights and obligations. However, such freedom extends to the contractual and not to the proprietary effects of the security agreement. Party autonomy applies to the parties to the security agreement (i.e. the secured creditor and the grantor), but should not affect the rights or obligations of persons not party to that agreement.

9. As it is not possible to foresee all the circumstances in which a security right may be required to secure the performance of an obligation, it is advisable to limit restrictions that hinder the ability of the parties to adapt a secured transaction to their own needs and circumstances. There must be, however, some restriction on party autonomy to prevent overreaching (for an example in the case of overcollateralization, see A/CN.9/WG.VI/WP.9/Add.1, paras. ...). Those restrictions should be clearly defined and based on grounds of public policy (*ordre public*), and particularly the principle of good faith and fair dealing.

10. Aside from such reasonable restrictions, which each jurisdiction will determine on the basis of their own public policy criteria, the parties should be given wide flexibility to:

- (i) Agree upon the terms of the security agreement;
- (ii) Define the obligation to be secured and the events triggering its default;  
and
- (iii) Determine what the grantor can and can not do with the encumbered assets.

### **3. Suppletive rules**

#### **a. Meaning**

11. The rules included in this Chapter are meant to apply only if the parties have not agreed otherwise. They apply automatically in the absence of evidence that the parties intended to exclude them. The conceptual vocabulary used to identify rules “subject to contrary agreement between the parties” varies from country to country (e.g. *jus dispositivum*, *lois supplétives*, *normas supletorias*, non-mandatory rules, default rules). Whatever terminology is used to formulate these rules, it should clarify that the rules apply and are enforceable only on the condition that the parties did not agree otherwise.

12. The suppletive rules discussed in this Chapter cover only the most regular incidents arising during the course of a secured transaction, i.e. the rights and obligations that the legislator fairly infers the parties would have most likely agreed upon but failed to address expressly in the security agreement.

#### **b. Policy objectives**

13. All suppletive rules should be based on policy objectives, such as reasonable allocation of responsibility for caring for the encumbered asset and preservation of pre-default value. Additional terms in the security agreement, aimed at enhancing the protection of secured lenders or grantors, are better left to the parties’ initiative. For example, the parties could specify in their agreement the law governing their mutual rights and obligations, or agree that the grantor would deposit any insurance proceeds obtained because of the loss of the encumbered asset in a given deposit account. These are mere illustrations of the many incidents, for which the contracting parties typically provide expressly in their agreement.

14. Suppletive rules should reflect the needs and practices of each jurisdiction. Yet, most jurisdictions are likely to agree on the advantages of adopting rules that are conducive to promoting access to credit at a lower cost and to encouraging responsible behaviour on the part of those having control and custody of encumbered assets. For example, most jurisdictions would agree with a suppletive rule that would provide for the right of the secured creditor to be reimbursed for reasonable expenses incurred to preserve the encumbered asset.

#### **c. Types of suppletive rules**

15. A distinction may be drawn between the rights and obligations of a secured creditor in possession of the encumbered assets (possessory security), those pertaining to the grantor in possession of the encumbered assets (non-possessory security), and those that are common to both possessory and non-possessory security rights.

##### **i. Possessory security rights**

16. In the context of possessory security rights, the suppletive rules should, at the very least, encourage the secured creditor to preserve the value of the encumbered assets, especially if those assets represent income-producing property. The following are among the most important duties and rights conferred on a secured creditor in possession of the encumbered assets.

**(a) Duty of care**

17. Responsible behaviour on the part of the secured creditor in possession may be encouraged by the imposition of an obligation to take reasonable care of the encumbered asset. While the parties may not exclude the duty of care or release the secured creditor from liability for its breach, they may vary the extent and the manner in which the duty of care may be exercised. The scope of the duty of care varies depending on the nature of the assets. In the case of tangible assets, the duty of care would go to the physical preservation of the assets (as to intangible assets, see paras. 19 and 34).

18. Depending on the circumstances, the duty of care may be discharged in different ways. In some cases, it may be unreasonable to expect the grantor to oversee the encumbered asset and more appropriate for the secured creditor in possession to carry out the duty of care. In other cases, it may be enough for the secured creditor to notify the grantor, who may be in a better position to take the steps necessary to preserve the asset (but not in the grantor's premises as return of the encumbered asset may result in the extinction of the security right). As it is not possible to detail in one suppletive rule the different meanings that the duty of care may take in different circumstances, it is advisable to draft such rule in broad terms.

**(b) Duty to take further steps to preserve the grantor's rights in intangibles**

19. If the encumbered asset consists of a right to payment of money embodied in a negotiable instrument, the duty of care is not limited to the physical preservation of the document embodying such right to payment. It also extends to the obligation to take necessary steps to maintain or preserve the grantor's rights against prior parties bound under the negotiable instrument. Those steps may include, for example, presentation of the instrument, protest, if required, and notice of dishonour. It is also incumbent upon a secured creditor in possession of an encumbered asset in the form of a negotiable instrument to preserve the grantor's rights by taking steps against persons secondarily liable under the instrument (e.g. guarantors).

**(c) Right to make reasonable use of the encumbered asset**

20. The secured creditor should be allowed to make use of or operate the encumbered asset for the purpose of its preservation and maintenance, although always in a manner and an extent that is reasonable.

**(d) Duty to keep the encumbered assets identifiable**

21. If the encumbered assets are of a non-fungible nature, the secured creditor must keep tangible assets in an identifiable form and not commingle such assets with other assets. If the encumbered assets are fungible and commingled with other assets of the same nature, then the secured creditor's duty to keep the encumbered assets identifiable becomes a duty to keep assets of the same quantity, quality and value as the assets originally encumbered.

**(e) Duty to allow inspection by grantor**

22. An additional obligation of the secured creditor in possession is to allow the grantor to inspect the encumbered assets at reasonable times.

**(f) Right to retain any proceeds or civil fruits as additional security**

23. The secured creditor should be able to hold monetary or non-monetary proceeds or “civil fruits” (see A/CN.9/WG.VI/WP.6/Add.3, paras. 36-37) derived from the encumbered asset. Monetary proceeds or civil fruits may be applied to the payment of the secured obligation, unless otherwise agreed by the parties in the security agreement.

**(g) Right to assign the secured obligation and the security right**

24. The secured creditor may assign the secured obligation and the security right (in some jurisdictions even despite contractual limitations on assignment; see article 9 (1) of the United Nations Assignment Convention). In exceptional cases, security rights may be assigned separately from the obligation they secure (e.g. in the case of a transfer of a security right of a parent corporation in the assets of a subsidiary to a financing institution for the purpose of ensuring new credit to the subsidiary).

**(h) Right to “repledge” the encumbered asset**

25. In some jurisdictions, the secured creditor may create a security right in the encumbered asset as security for a debt (“repledge the encumbered asset”) as long as the grantor’s right to obtain the assets upon payment of the secured obligation is not impaired. In other jurisdictions, the secured creditor in possession is not entitled to repledge the encumbered asset, even if it does so on terms that do not impair the grantor’s right to get the asset back upon performance of the secured obligation. In the context of secured transactions relating to investment property, however, the secured creditor’s right to repledge is a matter of common practice (security rights in investment property, however, are beyond the scope of this Guide).

**(i) Right to insure against loss or damage of the encumbered asset**

26. The risk of loss or deterioration of the encumbered assets remains on the grantor despite the creation of a security right (in most legal systems the grantor retains a property right in the encumbered asset). Yet, it is in the interest of the secured creditor to keep the encumbered asset insured in full. Therefore, the secured creditor should be entitled to contract insurance on behalf of the grantor and be reimbursed for that expense.

**(j) Right to pay taxes on behalf of the grantor**

27. Taxes assessed against the encumbered assets also fall under the responsibility of the grantor. However, a secured creditor should be entitled to pay those taxes on the grantor’s behalf to protect its security right in the assets. Such payment should be regarded as a reasonable charge incurred in the preservation of the encumbered asset for which the secured creditor should be entitled to reimbursement.

**(k) Right to be reimbursed for reasonable expenses**

28. Expenses that are necessary for the custody and preservation of the encumbered assets while in the possession of the secured creditor should be borne by the grantor. If those expenses are incurred by the secured creditor in possession of the encumbered asset and pursuant to its duty of care, the secured creditor has the right to be reimbursed by the grantor for those expenses. Insurance premiums (see

para. 26) and tax payments (see para. 27) are examples of reasonable expenses chargeable to the grantor and for which the secured creditor is entitled to reimbursement.

29. The security agreement may provide for other ways of allocating the expenses associated with the preservation and care of the encumbered assets. Moreover, the security agreement may provide for other types of expenses, which are incurred to protect the secured creditor's own interest in the encumbered assets rather than that of the grantor. Even if those expenses are reasonable, they should not be chargeable to the grantor as a matter of suppletive law. Payment for those expenses may, however, be allocated to the grantor if so agreed in the security agreement.

**(l) Duty to return the encumbered asset**

30. Upon full payment of the secured obligation, the secured creditor in possession must return the encumbered asset to the grantor. As the secured creditor cannot contract out of this obligation, it is normally part of a mandatory rather than suppletive rule.

**ii. Non-possessory security**

31. A key policy objective of an effective secured transactions regime is to encourage responsible behaviour by the grantor who remains in possession of the encumbered assets (see A/CN.9/WG.VI/WP.6/Add.1, para. 33). Accordingly, the policies underlying the suppletive rules for non-possessory security are aimed at maximizing the economic potential of the grantor's assets (see A/CN.9/WG.VI/WP.6/Add.1, para. 28). Encouraging the economic utilization of the grantor's assets facilitates the generation of revenue for the grantor. Maintaining the pre-default value of the encumbered assets is consistent with the objective of maximizing the realization value of those assets for the benefit of the secured creditor.

**(a) Duty to allow the secured creditor to inspect**

32. The secured creditor should have the right to monitor the conditions in which the encumbered asset is kept by the grantor in possession. To this effect, the grantor should be bound to allow the secured creditor to inspect the encumbered assets at all reasonable times.

**(b) Duty to keep the encumbered assets properly insured and to pay taxes**

33. The duty of care allocated to the grantor in possession includes keeping the encumbered asset properly insured and ensuring that the property taxes are paid. If these expenses are incurred by the secured creditor, it has the right to be reimbursed by the grantor whose obligation to reimburse is secured by the security right (see paras. 26 and 27).

**(c) Duty to take steps to preserve rights in the encumbered assets**

34. In the case of intangible encumbered assets, such as the grantor's right to payment in the form of receivables (e.g. deposit accounts, royalties or rights on account of patents, copyrights and trademarks), the main component of the grantor's obligation of care is the taking of necessary steps to preserve those rights, regardless

of whether or not they are represented in a negotiable instrument (as to rights represented in a negotiable instrument, see para. 19).

**(d) Right to receive proceeds or “civil fruits”**

35. Any increase in value or profit deriving from the encumbered assets in the grantor’s possession, regardless of whether those additional assets are regarded as civil or natural fruits or proceeds (for a discussion of this issue, see A/CN.9/WG.VI/WP.9/Add.1, paras. ...), is automatically subject to the security right held by the secured creditor, unless otherwise agreed (see para. 23).

**(e) Duty to account and to keep adequate records**

36. If the encumbered assets consist of income-producing property in possession of the grantor, to the extent that the security right extends to the income or revenues generated by the asset, the grantor’s duties may include maintaining adequate records and the reasonable rendering of accounts regarding the disposition and the handling of the proceeds derived from the encumbered assets.

**(f) Right to use, dispose, mix, process and commingle the encumbered assets**

37. The grantor in possession is entitled to use, mix, process and commingle the encumbered assets with other assets. In principle, the grantor should not be entitled to dispose of the encumbered assets without authorization of the secured creditor. By way of exception, however, the grantor may dispose of the encumbered assets as long as the disposal is in the ordinary course of the grantor’s business (see A/CN.9/WG.VI/WP.9/Add. 3, paras. ...).

38. In the case of disposition of the encumbered assets resulting in the extinction of the security right over those assets, the security right may extend to the proceeds (for a discussion of this issue, see A/CN.9/WG.VI/WP.6/Add.3, paras. 41-47).

**(g) Right to grant another security right in the same asset**

39. The grantor should be entitled to confer a subsequent security right over an already encumbered asset.

**(h) Duty of secured creditor to cancel registration or to take other steps**

40. Upon full performance of the secured obligation, the secured creditor must release the encumbered asset from the security right and request the cancellation of the registration of the security right or take any other steps conducive to giving notice that the grantor’s assets are no longer subject to a security right (as the secured creditor may not contract out of this obligation, it is normally part of mandatory rather than suppletive law).

**iii. Possessory and non-possessory security**

**(a) Duty of care**

41. If the encumbered asset is a tangible asset, the duty of care relates mainly to the preservation of the asset (see para. 17). If the encumbered asset is an intangible, the secured creditor’s duty of care extends to both the physical preservation of any

instrument and to taking the necessary steps to defend and enforce the right to payment incorporated in the instrument (see also paras. 19 and 34).

**(b) Grantor's duty to make up for unexpected devaluation**

42. If the value of the encumbered assets were to decrease significantly for reasons that were unforeseeable at the time of the conclusion of the security agreement, the grantor may have to offer additional security to make up for the unexpected and significant decrease in value.

43. As to expected deterioration of the value of the encumbered asset due to the passage of time or market conditions, the parties to the security agreement may wish to provide that, if such deterioration were to reach a significant mark, the grantor should offer additional security or the secured creditor may consider this as an event of default.

**(c) Right to assign the security right together with the secured obligation**

44. A secured creditor may freely assign the secured obligation in which case the security right normally follows (see, for example, article 10 of the United Nations Assignment Convention; in some cases, the secured creditor may assign the security right without the secured obligation; see para. 24). After such an assignment, the assignee-transferee inherits all the rights and obligations of the original secured creditor.

**(d) Secured creditor's duty to return the encumbered asset or otherwise release the security right**

45. Upon full performance of the secured obligation, the secured creditor in possession must return the encumbered asset to the grantor (see para. 30). In the case of non-possessory security registered in a public registry, the secured creditor has to request the cancellation of the security right or to file a notice of release of the encumbered asset (see para. 40).

## **B. Summary and recommendations**

46. The suppletive rules included in this Chapter seek to clarify the pre-default rights and obligations of the parties to the security agreement. These rules only pertain to the contractual rights and obligations of the parties prior to default, to the exclusion of the proprietary effects of the security agreement and the relationship between the parties after default.

47. The rules are permissive rather than mandatory, so that the expression "unless otherwise agreed" should be read as a preamble to each of the rights and duties allocated to the parties under these rules. A corollary of the permissive nature of these rules is that the parties may waive or vary the rights and obligations allocated to them, unless such waiver is against public policy or in conflict with an overriding principle of good faith and fair dealing.

48. In principle, the parties to a secured transaction should be free to agree on the terms of their relationship subject to the limits imposed by public policy (*ordre public*) and the protection of third parties. For example, the secured creditor in



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possession cannot contract out of the duty to return the encumbered asset to the grantor upon payment of the secured obligation (see paras. 30, 40 and 45).

49. A secured creditor in possession of the encumbered asset should care for, preserve and maintain the asset in good condition. The secured creditor is also bound to undertake all necessary repairs to keep the encumbered asset in such condition. In the case of tangible encumbered assets, the secured creditor should keep those assets properly identifiable. If those assets are fungible, the duty of care extends to an obligation to preserve encumbered assets of the same quantity, quality and value.

50. Where the encumbered asset consists of the grantor's right to the payment of money, whether or not that right is embodied in an instrument, the obligation of care on the part of the secured creditor should include the duty to preserve the grantor's rights against persons secondarily liable.

51. The secured creditor in possession should allow the grantor to inspect the encumbered asset at all reasonable times. Upon full satisfaction of the secured obligation, the secured creditor should return the encumbered asset to the grantor.

52. The secured creditor in possession may be entitled to retain as additional security any increase in value or profit deriving from the encumbered asset. In the case of cash proceeds, the secured creditor may apply them to the payment of the secured obligation or remit them to the grantor.

53. Except in limited circumstances, the secured creditor may not create a security right in the encumbered assets in its possession.

54. Reasonable expenses incurred by the secured creditor while discharging the obligation of custody and care (including the cost of insurance and payment of taxes) must be reimbursed to the secured creditor. The secured creditor's right to be reimbursed for those expenses should also be secured by the encumbered asset.

55. In the context of non-possessory security, the grantor who remains in possession of the encumbered assets should also be bound by a duty of custody and preservation. In fulfilling this duty, the grantor has to bear the necessary expenses, such as insurance premiums, taxes and other charges.

56. The grantor in possession should be entitled to use, mix, process and commingle the encumbered assets with other assets, as well as to dispose of the encumbered assets in the ordinary course of its business. The security right may continue in the proceeds or "civil fruits" deriving from the encumbered asset.

57. The grantor in possession may grant a subsequent security right in the encumbered assets.

58. The grantor in possession should allow the secured creditor to monitor the encumbered assets at reasonable times. In the case of income-producing encumbered assets, it is the grantor's duty to keep reasonable records detailing the ways of disposing of encumbered assets and handling the proceeds.

59. If the encumbered assets consist of intangibles, the grantor's obligation of care extends to asserting or defending the grantor's right to be paid or to taking the necessary steps to collect the debt owed to the grantor.

60. Upon performance in full of the secured obligation, it is the duty of the secured creditor to request the cancellation of the registration of the security right or to take any other step aimed at giving notice to third parties that the encumbered assets are no longer encumbered.

**Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fourth session**

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## IX. Insolvency

### A. General remarks

#### 1. Introduction

1. In principle, the effectiveness and priority of a security right should be recognized and the economic value of the security right preserved in an insolvency proceeding. An insolvency regime, however, may modify the rights of secured creditors in order to implement broad social and economic policies (e.g. protecting unsecured creditors and workers). If an insolvency regime does so, creditors whose security rights might be modified may quantify this risk and incorporate it into their assessment of whether to extend credit and on what terms. Therefore, there are benefits for a State that wishes to encourage credit markets by means of a modern secured transactions regime in coordinating that regime with the insolvency regime.

This chapter examines the relationship between the two regimes. It should be read together with the UNCITRAL Legislative Guide on Insolvency Law, which addresses the issues identified here in the broader context of insolvency law (see A/CN.9/WG.V/WP.63 and addenda). Conflict of laws issues arising with respect to security rights in insolvency proceedings are discussed in chapter X.

2. Secured transactions laws and insolvency laws have overlapping concerns and objectives. Both are concerned with debtor-creditor relations and both encourage credit discipline on the part of debtors. Both also share the objective of the recognition of security rights and the economic value of those rights. Effective regulation in either area will contribute to positive outcomes in the other. A secured transactions law, for example, may expand the availability of credit, thus facilitating the operation of a business and the avoidance of insolvency. A secured transactions law may also promote responsible behaviour on the part of both creditors and debtors by encouraging creditors to monitor the ability of debtors to perform their obligations, thereby discouraging over-indebtedness and consequent insolvency. Moreover, a secured transactions law that provides for a public record of security rights will make it easier for an insolvency administrator to promptly identify potential secured creditors (see A/CN.9/WG.VI/WP.9/Add.2, paras. ...).

3. Nevertheless, there are tensions where secured transactions and insolvency law intersect because of the different approaches taken to discharging debts or other obligations. A secured transactions regime seeks to ensure that the value of the encumbered assets protects the secured creditor when the obligations owed to the secured creditor are not satisfied, while an insolvency regime deals with circumstances where obligations owing to all creditors cannot be satisfied in full. In addition, the former regime focuses on effective enforcement rights of individual creditors to maximize the likelihood that the obligations owed are performed or their economic value realized. The latter regime, on the other hand, seeks to maximize the return to all creditors by preventing a race between creditors to enforce individually their rights against their common debtor.

4. Legislators revising existing laws or introducing a new regime in the field of secured transactions might acknowledge these tensions by ensuring the reconciliation of proposed legislation with the existing or proposed insolvency regime. A modification to the rights of secured creditors through either regime should be based on carefully articulated policies and be stated clearly and consistently in legislation, since reform in one regime can impose unforeseen transaction and compliance costs on stakeholders of the other regime.

## **2. Security rights in insolvency proceedings**

5. Modern insolvency regimes generally provide for two main types of proceedings: liquidation and reorganization. In a liquidation proceeding, the insolvency representative gathers the insolvent debtor's assets, sells or otherwise disposes of them and distributes the proceeds to the insolvent debtor's creditors. Assets may be liquidated individually, either all at once or in stages, or as part of the business as a going concern. In the case of liquidation of individual assets in stages or as part of the business as a going concern, the insolvent debtor's business may have to be continued.

6. In a reorganization proceeding, on the other hand, the objective of the proceeding is to continue the insolvent debtor's business as a going concern if economically feasible, to capture for all the stakeholders the premium of the business's going concern value over its liquidation value (see paras. 42-47). Expedited reorganization proceedings are also evolving that encourage prompt judicial or administrative confirmation in a formal reorganization proceeding of an agreement reached by the principal creditors or classes of creditors before an insolvency proceeding commences (e.g., reorganization dealing only with certain classes of debt, such as financial debt; see paras. 48-51).

**a. The inclusion of encumbered assets in the insolvency estate**

7. An initial question is whether the encumbered assets are part of the "insolvency estate" created when insolvency proceedings are commenced against an insolvent debtor (see A/CN.9/WG.V/WP.63/Add.5, paras. 60-62 and 66, and Recommendation 27). The debtor or the third-party grantor may be "the insolvent debtor". [*Note to the Working Group: The definition of insolvent debtor in A/CN.9/WG.VI/WP.6/Add.1, para. 14, will have to be adjusted.*] When the debtor and the grantor are two different persons, in the case of the insolvency of the grantor, the assets are part of the estate and, in the case of the insolvency of the debtor, the assets of the third-party grantor that are in the possession of the debtor may be affected (see A/CN.9/WG.V/WP.63/Add.7, paras. 115-117 and recommendations 46-47).

8. Inclusion of encumbered assets within the insolvency estate can give rise to different effects. In many jurisdictions, inclusion of encumbered assets in the estate will limit a secured creditor's ability to enforce its security right (see para. 20). Any such legislative limitations on commercial agreements will be taken into account by creditors when deciding whether to extend credit to a debtor, and at what cost. Some insolvency laws that require all assets to be subject to insolvency proceedings in the first instance allow the separation of encumbered assets from the estate where there is proof of harm or prejudice to the economic value of the security right or where the particular assets are shown to be fully encumbered and unnecessary to the reorganization.

9. To allow for an assessment of whether the continuation of the proceedings will maximize the eventual return to all creditors, an insolvency law may subject the encumbered assets to control within the insolvency proceedings. As a consequence, a secured creditor may be prohibited from taking possession of encumbered assets or, if it is in possession, may be required to surrender possession to the insolvency representative. This approach may be taken not only in reorganization proceedings, but also in liquidation proceedings in which the insolvent debtor's business is to continue while assets are liquidated in stages, or there is a likelihood that the business may be sold as a going concern. As it may not be possible to know at the commencement of insolvency proceedings whether it is desirable to continue the business, many insolvency regimes include the encumbered assets in the estate at least for a limited time period.

10. An insolvency estate will normally include all assets, tangible (movable or immovable) or intangible, in which the insolvent debtor has a right (ownership or other property or contractual right) at the time insolvency proceedings are commenced. What exactly is part of the estate may depend on whether an asset is

encumbered or not, or is held subject to an executory contract with a third person, such as a contract of sale or lease. In any case, the asset or the contractual rights that the insolvent debtor has in relation to the encumbered assets will be part of the estate, and the net value of the asset or the contractual right should be the same (i.e. the value of the asset less the secured debt).

11. In those jurisdictions where transfers of title for security purposes are treated as title devices, even in the case of insolvency, the assets transferred by the insolvent debtor to the creditor are not part of the insolvency estate (see A/CN.9/WG.VI/WP.9/Add.1, para. 31). However, the price paid and any relating rights are part of the estate. In the jurisdictions where such transfers of title are treated as security devices, the assets are part of the insolvency estate (see A/CN.9/WG.VI/WP.9/Add.1, para. 32).

12. Whether retention of title is assimilated to a security right or not, the assets are not necessarily part of the insolvency estate. A jurisdiction may, for example, wish to protect suppliers or other purchase-money financiers from the claims of other creditors when the assets and affairs of their common debtor are liquidated in an insolvency proceeding. Even these jurisdictions might not extend this exclusion to reorganization proceedings because of an overriding policy objective of continuing potentially viable businesses.

13. Typically, a sales contract with a retention of title clause is treated as an executory contract. The insolvency representative may choose to pay the balance of the purchase price and to bring the assets into the estate or to avoid the contract and to claim the part of the price that was paid by the insolvent debtor. If the insolvency representative chooses not to pay, the seller can reclaim the assets as an owner or insist on the payment of the outstanding purchase price.

14. Where the value of the encumbered assets is greater than the secured claim, any surplus remaining after liquidation and payment of the secured claim is part of the estate. In the absence of insolvency, the secured creditor would have to account to the grantor for the surplus proceeds. If the same assets are disposed of during insolvency proceedings, the surplus would be available for distribution to other creditors.

15. With respect to the treatment of a surplus in the case of retention of title arrangements, legal systems differ. In some systems, the seller is entitled to retain any surplus remaining after the sale of the asset and the satisfaction of the seller's claim, while in other legal systems the seller has to turn any surplus over to the insolvency estate. The issue might depend on whether such arrangements are treated as secured transactions or title devices and on whether the relevant contract is continued or terminated by the insolvency representative (see paras. 12-13).

16. The time and manner for determining the economic value of a security right may be provided for in insolvency law. A common approach is for the value to be determined at the time that the insolvency proceeding formally commences. [*Note to the Working Group: This matter is not covered in the Insolvency Guide.*] The manner for determining the value will ordinarily be related to the procedure for the recognition of the validity of claims against the insolvent debtor's estate (for the variety of possible mechanisms for the admission of claims, including secured claims, see A/CN.9/WG.V/WP.63/Add.13).

17. Outside insolvency, a security agreement may provide that a security right includes the proceeds of encumbered assets and after-acquired assets. An insolvency law may address the issue of whether the secured creditor continues to be entitled to these proceeds and assets acquired after the commencement of insolvency proceedings.

18. Proceeds received on the disposition of encumbered assets in effect are a substitute for those assets and, in principle, secure the economic value of the security right. Proceeds in the form of fruits and products of encumbered assets are not literally substitutes but represent natural increases which all parties expect to be subject to the security right. To the extent, however, that the insolvency representative incurs expenses in connection with these proceeds, the secured creditor rather than the estate should ultimately bear the burden of these expenses.

19. Assets acquired by the estate after the commencement of the insolvency proceedings in which the secured creditor might have a right outside insolvency are not substitutes of encumbered assets or the natural fruits or products of those assets. In the absence of new financing by the secured creditor, the case for recognizing the creditor's right in these new assets is less compelling.

**b. Limitations on the enforcement of security rights**

20. Upon commencement of insolvency proceedings, many insolvency laws impose a stay or moratorium on acts by creditors to enforce their claims or pursue any remedies or proceedings against the insolvent debtor. The stay may be imposed either automatically or at the discretion of a court, either on its own motion or on application of an interested party. A number of jurisdictions extend the stay to both unsecured and secured creditors. The same reasons for including encumbered assets within the estate apply to the stay of enforcement of security rights (see para. 8). Limitations, however, on a secured creditor's ability to enforce its security right may have an adverse impact on the cost and availability of credit. An insolvency law must balance these competing interests (see A/CN.9/WG.V/WP.63/Add.6, paras. 73, 75-78, 80-83, 84, 87, 91-92, 94 and 96-102, as well as recommendations 40-42).

21. If an insolvency proceeding commences only when the court decides on an application to commence insolvency proceedings, the court may be authorized to order protective measures to preserve the estate in the period between the application and the court's decision on the application. The court might order these protective measures at its discretion, either on its own motion or on application of an interested party. Where these provisional measures are available they may include staying a secured creditor from taking possession of encumbered assets or otherwise enforcing its security right. Because these measures are provisional and are ordered before the decision to commence proceedings, creditors requesting these measures may be required by the court to provide evidence that the measure is necessary and, in some cases, some form of security for costs or damages that may be incurred.

22. The need to stay enforcement of a security right for a substantial period of time is less compelling in liquidation proceedings if assets are disposed individually rather than as a going concern. Different approaches may be adopted. For example, an insolvency regime may exclude secured creditors from the application of the

stay, but encourage negotiations between the insolvent debtor and the creditors prior to commencement of the insolvency proceedings to achieve the best outcome for all parties. An alternative approach would provide that in insolvency proceedings the stay lapses after a brief prescribed period of time (e.g. 30 days) unless a court order is obtained, extending the stay on grounds specified in the insolvency law. These grounds might include a demonstration that there is a reasonable possibility the business will be sold as a going concern; this sale will maximize the value of the business; and secured creditors will not suffer unreasonable harm. Yet another approach is to leave the lifting of the stay to the discretion of the court supervising the insolvency proceedings but to provide statutory guidelines for the exercise of this discretion.

23. A stronger case for a stay is made when the insolvency proceeding is a reorganization proceeding. Removal of encumbered assets from the business will often defeat attempts to continue the business or to sell it as a going concern. Accordingly, an insolvency law might extend the application of a stay to secured creditors for the time period necessary for the formulation, approval and implementation of a reorganization plan (see A/CN.9/WG.V/WP.63/Add.6, para. 91).

24. If an enforcement action by a secured creditor is stayed, an insolvency regime should provide safeguards to protect the economic value of the security rights in the encumbered assets. Such safeguards might include court orders for cash payments for interest on the secured claim, payments to compensate for the depreciation of the encumbered assets, and extension of the security right to cover additional or substitute assets. The need for such safeguards is particularly compelling when the encumbered assets are perishable or consumable (such as cash or cash equivalents). The standard against which the safeguards might be assessed might be the position the secured creditor would have been in had it enforced its security prior to the commencement of insolvency proceedings.

25. In addition, an insolvency law might also relieve a secured creditor from the burden of a stay by authorizing the insolvency representative to release the encumbered assets to the secured creditor. Grounds for such a release might include: cases where the encumbered assets are of no value to the estate and are not essential for the sale or rehabilitation of the business; cases where it is not feasible or is overly burdensome to protect the value of the security right; and cases where the insolvency representative has failed in a timely fashion to sell or otherwise dispose of the encumbered assets. An insolvency law might also provide that, once the stay has been terminated with respect to particular encumbered assets, the secured creditor could use, at its cost and if it wished, procedures in the insolvency proceeding to sell or otherwise dispose of the encumbered assets.

26. Where encumbered assets are necessary for the conduct of the insolvency proceedings, the insolvency representative may be entitled to use them, while providing protection of the value of the security right. In addition, the insolvency representative may be entitled to dispose of the encumbered assets free of any security right, provided that it notifies the secured creditor, the secured creditor is given the opportunity to object, no relief from the stay is granted and the priority of the secured creditor in the proceeds of the disposition is preserved (see A/CN.9/WG.VI/WP.63/Add.7, paras. 269, 278-280 and 292, as well as recommendations 44-45 and 51).



27. If the applicable secured transactions law authorizes the secured creditor to dispose of an asset outside insolvency, the question arises whether the secured creditor, rather than the insolvency representative, should control disposition of the relevant encumbered assets during insolvency. An insolvency law might provide that, in a liquidation procedure, the court may order that the encumbered assets be turned over to the secured creditor if the value of the encumbered assets is not sufficient to meet the secured obligation and there is a reasonable indication that the secured creditor would sell them more easily and at a better price. [*Note to the Working Group: This matter is addressed in more general terms in recommendation 42 contained in the Insolvency Guide.*] In any event, the insolvency law should make clear that any surplus after paying reasonable expenses and satisfying the secured claim should be returned to the insolvency estate.

**c. Participation of secured creditors in insolvency proceedings**

28. To the extent that encumbered assets are part of the insolvency estate and the rights of secured creditors are affected, secured creditors are given a right to participate effectively in the insolvency proceedings, including in any negotiations aimed at an amicable settlement. The extent of such participation is prescribed by insolvency law (see A/CN.9/WG.V/WP.63/Add.11, paras. 261-262, 269, 278-280 and 292, as well as recommendation 110). For example, secured creditors might participate in general creditor committees, eventually voting only on matters that affect encumbered assets, or in separate committees for secured creditors.

29. Where secured creditors rely on encumbered assets to pay all or part of their claims, the insolvency law might permit their participation in the proceedings to the extent that their claim is unsecured. Where secured creditors have surrendered their security right to the insolvency representative, the insolvency law might enable them to participate in the proceedings to the same extent as ordinary unsecured creditors. Where a secured creditor's claim is to be modified under a reorganization plan, the secured creditor might be entitled to participate in the reorganization proceedings.

**d. The effectiveness of security rights and avoidance actions**

30. In general, a security right that is effective against the insolvent debtor and third parties outside of insolvency should be recognized as effective in an insolvency proceeding. However, a challenge to the effectiveness of a security right in insolvency proceedings is normally allowed on the same grounds that any other transaction might be challenged. The insolvency representative or the creditors may be authorized to seek to set aside ("avoid") or otherwise render ineffective any transactions intended to defeat, hinder or delay creditors ("fraudulent"), or preferential or undervalued transactions made by the insolvent debtor within a certain period before the commencement of insolvency proceedings (see A/CN.9/WG.V/WP.63/Add.9, para. 170 and recommendation 71).

31. The creation or transfer of a security right is a transfer of property subject to these general provisions, and if that transfer is fraudulent, preferential or undervalued, it may be avoided or otherwise rendered ineffective. This would mean that a security right, which is effective under the secured transaction regime of a jurisdiction, may be rendered ineffective, in certain circumstances, under the insolvency regime of the same jurisdiction. Therefore, there is a need for the

grounds for such avoidance of a security right to be stated in clear and predictable terms.

32. In the case of liquidation proceedings, payment of proceeds of encumbered assets is not only allowed but also required, unless such payment is voidable under other applicable principles.

**e. The relative priority of security rights**

33. A secured transaction regime establishes the priority of claims to encumbered assets. Certainty with respect to priority is essential for the availability and the cost of credit. It is, therefore, important for insolvency law to respect the priority of security rights existing before the commencement of insolvency proceedings (“pre-insolvency priority”). Any exceptions to this principle should be limited, in number and value, and the existence and amount of these exceptions should be expressed in a transparent and predictable way (see A/CN.9/WG.V/WP.63/Add.14, paras. 423-425, and recommendation 168). For example, the exceptions might be set forth, not only in labour or tax law, but also in insolvency and secured transactions law.

34. An example of such an exception to the principle of respecting the pre-insolvency priority of security rights relates to privileged claims (e.g. unpaid wages, employee benefits or tax claims). While most legal systems award these claims priority only over unsecured claims, some legal systems extend the priority to rank ahead of even secured claims. Another example of such an exception arises where a portion of the estate, including encumbered assets, is set aside for the benefit of some classes of unsecured creditors, such as employees or classes of persons injured by acts of the insolvent debtor.

35. As a general rule, the value of the encumbered assets is not subject to a surcharge for the general administration of the insolvency proceedings. The insolvency representative may, however, incur costs in the maintenance of encumbered assets and pay for these costs from the insolvency estate. Because such expenditure preserves the economic value of the security right, not to grant priority over the secured creditor for these administrative expenses would unjustly enrich the secured creditor to the detriment of the unsecured creditors. To discourage unreasonable expenditure, however, an insolvency law might limit such priority to the reasonable cost of foreseeable expenses that directly preserve or protect the encumbered assets.

**f. Post-commencement financing**

36. In order for an insolvency proceeding to yield the maximum return for all creditors, either through liquidation or reorganization, the insolvency representative must have sufficient funds available to it to fund the expenses of the liquidation or reorganization. In the case of liquidation, these expenses may include the cost of preserving and protecting the estate’s assets pending their sale or other disposition. In the case of reorganization, the expenses may include payroll and other operating expenses to enable the insolvent debtor to carry on its business as a going concern during the insolvency proceeding.

37. In some cases, the insolvency representative may already have sufficient liquid assets to fund such anticipated expenses, in the form of cash or other assets that will be converted to cash (such as anticipated proceeds of receivables). However, these

assets may already be subject to effective security rights held by the insolvent debtor's pre-existing creditors (such as a lender that has security rights in the insolvent debtor's receivables arising as proceeds from the sale of inventory). The use of such assets by the insolvency representative during the insolvency proceeding could well impair, or even destroy, the economic value of such security rights. As a result, an insolvency representative might only be permitted to use such assets in the insolvency proceeding to the extent that the rights of pre-existing secured creditors to receive the economic value of their security rights are protected. Otherwise, prospective secured creditors will be reluctant to extend credit to a (legal or natural) person knowing that, if that person were to become subject to an insolvency proceeding, they could lose the economic value of their security rights.

38. In other cases, the insolvency estate's existing liquid assets and anticipated cash flow may be insufficient to fund the expenses of the insolvency proceeding, and the insolvency representative must seek financing from third parties. Such financing may take the form of credit extended to the estate by suppliers of goods and services, or loans or other forms of credit extended by lenders. Often, these are the same suppliers and lenders that extended credit to the insolvent debtor prior to the insolvency proceeding. Typically, these providers of credit will only be willing to extend credit to an insolvency estate if they receive appropriate assurance (either in the form of a priority claim on, or security rights in, the assets of the estate) that they will be repaid. Yet here again, those assets may already be subject to effective security rights held by the insolvent debtor's pre-existing creditors and, for the reason described in the preceding paragraph, new creditors asked to extend credit to the insolvency estate are given a priority claim or security rights in the insolvent debtor's existing or future assets only to the extent that the economic value of any pre-existing security rights is protected.

39. Thus, in any of these financing arrangements (referred to collectively as "post-commencement financing") it is essential that the economic value of the security rights of pre-existing secured creditors is protected so that such creditors will not be unreasonably harmed. If encumbered assets are of a value significantly in excess of the amount of the obligations owed to pre-existing secured creditors, no special protection to the pre-existing secured creditors may be necessary initially (subject to the creditors' right to ask for protection at a later date if circumstances change). However, in many cases such excess value does not exist, and the pre-existing secured creditors should receive protection to preserve the economic value of their security rights. Measures to protect this value might include periodic payments or security rights in additional assets in substitution for the assets used by the insolvency representative or encumbered in favour of a new lender.

40. When providing protection to a pre-existing secured creditor, it is important that such creditor not receive greater rights than it would have been entitled to if there were no post-commencement financing. Thus, the granting of additional security rights should not result in the pre-existing creditor improving its pre-insolvency secured position by, for example, securing unsecured pre-insolvency obligations. Rather, any additional security rights granted to a pre-existing secured creditor should secure only the insolvency estate's obligation to reimburse the secured creditor for the decline in value of the encumbered assets subject to its pre-existing security rights.

41. An insolvency law might incorporate specific provisions for post-commencement financing to indicate the circumstances in which such financing may be provided, the rules applicable thereto, and the effect of such financing on the rights of all parties. Such legislation could provide that post-commencement financing that affects the rights of pre-existing secured creditors may be extended only by court order, provided that appropriate notice, as well as the right to be heard, is given to all affected parties. By providing explicit rules, an insolvency law enables a creditor to consider the possibility of post-commencement financing when extending credit to a solvent debtor. Explicit legislative guidance provides greater transparency and predictability than a regime that merely permitted negotiated agreements between the new creditor and the insolvency representative (for further discussion of this topic, see A/CN.9/WG.V/WP.63/Add.14, paras. 416-420 and recommendations 162-165).

**g. Reorganization proceedings**

42. The principal objective of reorganization proceedings is to maximize the value of the insolvency estate in the interest of all stakeholders by formulating a plan for the business's rescue. In order to achieve this objective, it may be necessary for a secured creditor to participate in the reorganization proceeding, especially if the encumbered assets must be used in order to reorganize the insolvent debtor's business (see A/CN.9/WG.V/WP.63/Add.12, paras. 321, 325, 327, 329-334, 349 and 351).

43. An important corollary to requiring the secured creditor to participate in the reorganization, however, is that the secured creditor should not be made against its will worse off than if the secured creditor resorted to its non-insolvency enforcement rights to dispose of the encumbered assets and applied the proceeds of the disposition to the secured obligations. As a general proposition, the economic value of the secured creditor's security rights should be preserved and maintained in the reorganization. Otherwise, the uncertainty created by the inability of the secured creditor to rely upon receipt of the economic value of its security rights in the event of the reorganization of the insolvent debtor in an insolvency proceeding could result in the secured creditor not extending credit to the debtor in the first place or extending the credit at a higher cost. Moreover, such preservation of value is also essential to attract the financing that the insolvent debtor will require in order to implement its reorganization plan and to operate as a rehabilitated enterprise.

44. If the secured creditor must participate in the reorganization, the proposed reorganization plan might contain provisions, which adversely affect its rights. The secured creditor may nevertheless agree to be bound by the reorganization plan. However, if the secured creditor does not agree to be bound by the reorganization plan, the question arises as to whether the reorganization plan may bind the secured creditor over the secured creditor's objection.

45. If insolvency law provides that a secured creditor may be bound by the reorganization plan over the secured creditor's objection, it should also preserve the basic protection that the economic value of the security rights should not be diminished under the plan without the consent of the secured creditor. At a minimum, the secured creditor should receive no less under the plan than it would have received in liquidation proceedings, unless it had consented to the reorganization plan. The protection of the secured creditor's security rights should

be clear and transparent under the insolvency law so that the secured creditor will be able to make its decision as to whether to extend credit and, if so, on what terms, with the certainty of knowing that its security rights will be appropriately protected in the case of insolvency and if a reorganization plan were to be adopted over the objection of the secured creditor's class or, as the case may be, of the secured creditor itself.

46. There are several examples of ways in which the economic value of security rights may be preserved in the reorganization plan even though the security rights are being altered by the plan. If the plan provides that the secured creditor would receive a cash payment under the plan in exchange for the secured obligations, the cash payment should not be less than what the secured creditor would have received in litigation. If the plan provides for the secured creditor to release its security rights in some encumbered assets, the plan should provide for substitute assets of at least equal value to become subject to the secured creditor's security rights, unless the remaining encumbered assets have sufficient value to enable the secured creditor to be paid in full upon any disposition of the remaining encumbered assets. If the plan subordinates the secured creditor's rights to those of another secured creditor, the encumbered assets should have sufficient value to enable both the first-ranking and the subordinated secured creditors to be paid in full upon any disposition of the encumbered assets. If the plan provides for the amount of the secured obligations to be paid over time, the secured creditor should retain its security rights and the current value of the future payments of the secured obligations. In addition, the interest rate on the modified secured obligations should not be less than the amount that the secured creditor would have received in litigation. [*Note to the Working Group: The Working Group may wish to note that this matter is not addressed in the draft Insolvency Guide.*]

47. Whether the economic value of the secured creditor's security rights is preserved in a reorganization plan may be more of a factual issue rather than a legal issue in many circumstances. In the event of a contest in the insolvency proceeding as to whether the economic value of the security rights is being preserved under the plan, the determination of value will often require consideration of markets and market conditions. The valuation may, indeed, require expert testimony, especially if the treatment of the secured creditor under the plan involves encumbered assets whose present value may be dependent upon the insolvent debtor's future performance and, therefore, may contain elements of performance risk to be factored into the determination of value. Absent agreement among the contesting parties, the court will have to decide on the evidence presented whether the economic value of the security rights is being preserved.

#### **h. Expedited reorganization proceedings**

48. In recent years, significant attention has been given to the development of expedited reorganization proceedings ("expedited proceedings") as a means of streamlining the reorganization of an insolvent debtor, without the cost or delay inherent in formal reorganization proceedings, in situations where all or substantially all of the insolvent debtor's major creditors (usually other than trade creditors) are able to reach an agreement as to the terms of the reorganization (see A/CN.9/WG.V/WP.63/Add.12, para. 369).

49. Expedited proceedings may take the form of a procedure in which: (i) the creditors first conduct negotiations concerning the terms of a proposed reorganization plan prior to the commencement of a formal insolvency proceeding; (ii) a formal insolvency proceeding is then commenced; and (iii) the reorganization plan is presented to the court for its approval on an expedited basis (but subject to the same requirements for disclosure to, and voting by, all of the insolvent debtor's creditors and other procedural requirements that are applicable in formal reorganization proceedings). When approved, the reorganization plan would bind dissenting creditors in the same manner as in a formal reorganization proceeding. Some proposals for expedited proceedings contemplate less involvement by the court, and rely primarily on agreements by the major creditors of the insolvent debtor, with resort to the court only for limited purposes.

50. From the perspective of promoting the availability of low-cost secured credit, it is essential that expedited proceedings not frustrate the reasonable expectations of secured creditors, or create a situation in which a secured creditor is worse off in such proceedings than it would be in a formal insolvency proceeding. Thus, for example, an expedited proceeding should not, without the secured creditor's consent, deprive that creditor of its ability to realize the full economic value of its encumbered assets, and should reasonably compensate the secured creditor for any diminution in that value resulting from the use of such assets by the insolvent debtor during the proceeding. Moreover, the expedited proceeding should not frustrate the reasonable expectations of the secured creditor under its credit documents and the applicable law with respect to choice of law or choice of forum.

51. As a general matter, the existence, in a given jurisdiction, of properly constructed expedited proceedings that adhere to the principles discussed above would encourage creditors to extend secured credit in that jurisdiction.

## **B. Summary and recommendations**

52. In principle, encumbered assets should be included in the insolvency estate. If the underlying transaction is a title transaction (transfer of title or retention of title), the assets or the rights of the insolvent debtor relating to the assets should be part of the estate (see paras. 7-19).

53. Encumbered assets should be subject to the stay and other related limitations imposed. The insolvency law should specify the requirements, duration and the effects of the stay and related limitations, as well as the grounds for relief may be granted to secured creditors. In any case, the value of security rights should be sufficiently protected (see paras. 20-27).

54. If the rights of secured creditors are affected, the insolvency regime should enable them to participate in insolvency proceedings effectively to protect their rights (see paras. 28-29).

55. Subject to any avoidance actions, security rights created before the commencement of an insolvency proceeding should be equally effective in an insolvency proceeding (see paras. 30-32).

56. As a general rule, insolvency proceedings should not alter the priority of secured claims prevailing before the commencement of the insolvency proceedings.

Certainty and transparency with respect to any necessary exceptions will help limit the negative impact on the availability and cost of credit (see paras. 33-35).

57. An insolvency law should incorporate specific provision for post-commencement financing so that a creditor extending credit before an insolvency proceeding is commenced may take into account the possibility of post-commencement financing before extending the credit (see paras. 36-41).

58. An insolvency law should enable secured creditors to participate in reorganization proceedings. The economic value of security rights should be preserved and, at a minimum secured creditors should receive no less than what they would have received in a liquidation proceeding (see paras. 42-47).

59. Expedited proceedings should not leave a secured creditor worse off than it would be in a formal insolvency proceeding, unless the secured creditor expressly consents (see paras. 48-51).

**Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fourth session**

ADDENDUM

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## **X. Conflict of laws**

### **A. General remarks**

#### **1. Introduction**

##### **a. Purpose of conflict-of-laws rules**

1. This Chapter discusses the rules for determining the law applicable to the creation, publicity, priority and enforcement of a security right. These rules are generally referred to as conflict-of-laws rules and also determine the territorial scope of the substantive rules envisaged in the Guide (i.e. if and when the substantive rules of the State enacting the regime envisaged in the Guide apply). For example, if a State has enacted the substantive law rules envisaged in the Guide



relating to the priority of a security right, these rules will apply to a priority contest arising in the enacting State only to the extent that the conflict-of-laws rule on priority issues points to the laws of that State. Should the conflict rule provide that the law governing priority is that of another State, then the relative priority of competing claimants will be determined in accordance with the law of that other State, and not pursuant to the substantive priority rules of the enacting State.

2. After a security right has become effective, a change might occur in the connecting factor for the choice of the applicable law. For instance, if security over tangible goods located in State A is governed by the law of the location of the goods, the question arises as to what happens if those goods are subsequently moved to State B (whose conflict rules also provide that the location of the goods governs security rights over tangible property). One alternative would be for the security to continue to be effective in State B without the need to take any further step in State B. Another alternative would be for new security to be obtained under the laws of State B. Yet another alternative would be for the secured creditor's pre-existing right to be preserved subject to the fulfilment in State B of certain formalities within a certain period of time (e.g. 30 days after the goods have been brought into State B). These issues are addressed by the conflict-of-law rules of some legal systems. This Chapter proposes a general rule in this regard.

3. Conflict-of-laws rules should reflect the objectives of an efficient secured transactions regime. Applied to the present Chapter, this means that the law applicable to the property aspects of a security right should be capable of easy determination: certainty is a key objective in the elaboration of rules affecting secured transactions both at the substantive and conflict-of-laws levels. Another objective is predictability. As illustrated by the questions in the preceding paragraph, the conflict-of-laws rules should permit the preservation of a security right acquired under the laws of State A if a subsequent change in the connecting factor for the selection of the applicable law results in the security right becoming subject to the laws of State B. A third key objective of a good conflict-of-laws system is that the relevant rules must reflect the reasonable expectations of interested parties (creditor, grantor, debtor and third parties). According to many, in order to achieve this result, the law applicable to a security right should have some connection to the factual situation that will be governed by such law.

4. Use of the Guide (including this Chapter) in developing secured transactions laws will help reduce the risks and costs resulting from differences between current conflict-of-laws rules. In a secured transaction, the secured creditor normally wants to ensure that its rights will be recognized in all States where enforcement might take place (including in a jurisdiction administering the insolvency of the grantor). If those States have different conflict-of-laws rules in relation to the same type of encumbered assets, the creditor will need to comply with more than one regime in order to be fully protected. A benefit of different States having harmonized conflict-of-laws rules is that a creditor can rely on one single law to determine the priority status of its security in all such States. This is one of the goals achieved in respect of receivables by the United Nations Assignment Convention and in respect of indirectly-held securities by the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.

5. It is worth noting that conflict-of-laws rules would be necessary even if all States had harmonized their secured transactions laws. There would remain

instances where the parties would have to identify the State whose requirements will apply. For example, if the laws of all States provided that publicity of a non-possessory right is made by filing in a public registry, one would still need to know in which State's registry the filing must be made.

**b. Scope of the conflict-of-laws rules**

6. This Chapter does not define the security rights to which the conflict-of-laws rules will apply. Normally, the characterization of a right as a security right for conflict-of-laws purposes will reflect the substantive security rights law in a jurisdiction. In principle, a court will use its own law whenever it is required to characterize an issue for the purpose of selecting the appropriate conflict-of-laws rule. The question arises, however, as to whether the conflict-of-laws rules for security rights should also apply to other transactions that are functionally similar to security, even if they are not covered by a secured transactions regime. To the extent that title reservation agreements, financial leases, consignments and other similar transactions would not be governed by the substantive law provisions governing secured transactions, a State might nonetheless subject these devices to the conflict-of-laws rules applicable to secured transactions.

7. A similar issue arises in respect of certain transfers not made for security purposes, where it is desirable that the applicable law for creation, publicity and priority be the same as for a security right over the same category of property. An example is found in the United Nations Assignment Convention, which (including its conflict-of-laws rules) applies to outright transfers of receivables as well as to security rights over receivables (see art. 2 (a)). This policy choice is motivated, *inter alia*, by the necessity of referring to one single law to determine priority between competing claimants to the same receivable. In the event of a priority dispute between a purchaser of a receivable and a creditor holding security over the same receivable, it would be more difficult (and sometimes impossible) to determine who is entitled to priority if the priority of the purchaser were governed by the laws of State A but the priority of the secured creditor were governed by the laws of State B.

8. Whatever decision a jurisdiction makes on the range of transactions covered by the conflict-of-laws rules, the scope of the rules will be confined to the property aspects of these transactions. Thus, a rule on the law applicable to the creation of a security right only determines what law governs the creation of a property right. The rule would not apply to the personal obligations of the parties under their contract. Such obligations are governed by the law applicable to contractual obligations, which subject to certain limitations, most legal systems permit the parties to freely choose in their contract.

9. A corollary to recognizing party autonomy with respect to the personal obligations of the parties is that the conflict-of-laws rules applicable to the property aspects of secured transactions are matters that are outside the domain of freedom of contract. For instance, the grantor and the secured creditor cannot be permitted to select the law applicable to priorities, since this could not only affect the rights of third parties, but also result in a priority contest between two competing secured creditors being subject to two different laws leading to opposite results.

## 2. Conflict-of-laws rules for creation, publicity and priority

10. The determination of the extent of the rights conferred by a security right generally requires a three-step analysis:

(a) The first issue is whether the security has been validly created (see Chapter IV);

(b) The second issue is whether the security is effective against third parties (see Chapter V); and

(c) The third issue is what is the priority ranking of the secured creditor (see Chapter VI).

11. Not all legal systems make specific conceptual distinctions among these issues. In some legal systems, the fact that a property right has been validly created necessarily implies that the right is effective against third parties. Moreover, legal systems that clearly distinguish among the three issues do not always establish separate substantive rules on each issue. For example, in the case of a possessory pledge complying with the requirements for the *in rem* validity of a security right generally results in the security being effective against third parties without any need for further action.

12. The key question is whether one single conflict-of-laws rule should apply to all three issues. The alternative is to allow for more flexibility, where it may be more appropriate that the law applicable to publicity or priority be different from that governing the creation of the right. Policy considerations, such as simplicity and certainty, favour adopting one rule for creation, publicity and priority. As noted above, the distinction among these issues is not always made or understood in the same manner in all legal systems, with the result that providing different conflict-of-laws rules on these issues may complicate the analysis or give rise to uncertainty. There are, however, instances where selecting a different law for priority issues would better take into account the interests of third parties such as persons holding non-consensual security.

13. Another important question is, whether on any given issue (i.e. creation, publicity or priority) the relevant conflict-of-laws rule should be the same for tangible and intangible property. A positive answer to that question would favour a rule based on the law of the location of the grantor. The alternative would be the place where the encumbered asset is held (*lex situs*), which would, however, be inconsistent in respect of receivables with the United Nations Assignment Convention (article 22 of which refers to the law of the State in which the assignor, i.e. the grantor, is located).

14. Simplicity and certainty considerations support the adoption of the same conflict-of-laws rule (e.g. the law of the grantor's location) for both tangible and intangible property, especially if the same law applies to creation, publicity and priority. Following this approach, one single enquiry would suffice to ascertain the extent of the security rights encumbering all assets of a grantor. There would also be no need for guidance in the event of a change in the location of encumbered assets or to distinguish between the law applicable to possessory and non-possessory rights (and to determine which prevails in a case where a possessory security right governed by the law of State A competes with a non-possessory security right over the same property governed by the law of State B).

15. Not all jurisdictions, however, regard the law of the location of the grantor as sufficiently connected to security rights over tangible property (for “non-mobile” goods at least). Moreover, the law governing security would need to be same as the law governing a sale of the same assets. This means that acceptance of the grantor’s law for every type of security would be workable only if jurisdictions, generally, were prepared to accept that rule for all transfers.

16. In addition, it is almost universally accepted that a possessory right should be governed by the law of the place where the property is held, so that adopting the law of the grantor for possessory rights would run against the reasonable expectations of non-sophisticated creditors. Accordingly, even if the law of the grantor’s location were to be the general rule, an exception would need to be made for possessory security rights.

17. As the applicable conflict rules might be different depending on the tangible or intangible character of the assets or the possessory or non-possessory nature of the security, the question arises as to which conflict rule is appropriate if intangible property is capable of being the subject of a possessory security right. In this regard, most legal systems assimilate certain categories of intangibles incorporated in a document (such as negotiable instruments and bills of lading) to tangible property, thereby recognizing that such assets may be pledged by delivering the document to the creditor. The pledge would then be governed by the law of the State where the document is held.

**[Note to the Working Group]**

*The scope of the law envisaged by this Guide is focused on commercial goods, equipment and trade receivables. If the Working Group decides to cover other categories of intangible property, such as non-trade receivables, bank deposits, letters of credit and intellectual property, it may wish to consider whether there should be any special conflict rules for these types of asset. In considering the matter, the Working Group may wish to take into account that assets within these categories of property often comprise a significant part of the value of an enterprise and that in particular the absence of a conflict-of-laws rule for intellectual property could cause great difficulties in commercial transactions.*

*With respect to conflict rules applicable to securities, the Working Group may wish to refer to the Hague Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary.]*

**3. Effect of subsequent change in the connecting factor**

18. Whatever connecting factor is retained for determining the most appropriate conflict-of-laws rule for any given issue, there might occur a change in the relevant factor after the security has been created. For example, where the applicable law is that of the jurisdiction where the grantor has its head office, the grantor might later relocate its head office to another jurisdiction. Similarly, where the applicable law would be the law of the jurisdiction where the secured property was located, the property might be moved to another jurisdiction.

19. If these issues are not dealt with specifically, an implicit rule might be drawn. The general conflict-of-laws rules on creation, publicity and priority might be

construed to mean that, in the event of a change in the relevant connecting factor, the original governing law continues to apply to issues that arose before the change (e.g. creation), while the subsequent governing law would apply to events occurring thereafter (e.g. a priority issue between two competing claimants).

20. The silence of the law on these matters might, however, give rise to other interpretations. For example, one interpretation might be that the subsequent governing law also governs creation in the event of a priority dispute occurring after the change (on the basis that third parties dealing with the grantor are entitled to determine the applicable law for all issues relying on the actual connecting factor, being the connecting factor in effect at the time of their dealings).

21. Providing a rule on these issues would appear to be necessary to avoid uncertainty, in particular where the connecting factor changes from a State that has not enacted the law envisaged by this Guide to an enacting State.

22. A similar issue arises with respect to goods in transit. Some legal systems provide that a security right over such goods may be validly created and publicized under the law of the place of destination if they are moved to that place within a specified time limit.

#### 4. Conflict-of-laws rules for enforcement issues

23. Where a security right is created and publicized under the law of one State, but is sought to be enforced in another State, an issue arises regarding what remedies are available to the secured creditor. This is of great practical importance where the substantive enforcement rules of the two States are significantly different. For example, the law governing the security could allow enforcement by the secured creditor without prior recourse to the judicial system unless there is a breach of peace, while the law of the place of enforcement might require judicial intervention. Each of the possible solutions to this issue entails advantages and disadvantages.

24. One option is to subject enforcement remedies to the law of the place of enforcement, i.e. the law of the forum (*lex fori*). The policy reasons in favour of this rule include that:

(a) The law of remedies would coincide with the law generally applicable to procedural issues;

(b) The law of remedies would, in many instances, coincide with the location of the property being the object of the enforcement (and could also coincide with the law governing priority if the conflict-of-laws rules of the relevant State point to the location for priority issues);

(c) The requirements would be the same for all creditors intending to exercise rights against the assets of a grantor, irrespective of whether such rights are domestic or foreign in origin.

25. On the other hand, the *lex fori* might not give effect to the intention of the parties. The parties' expectations may be that their respective rights and obligations in an enforcement situation will be those provided by the law under which the security was created. For example, if extra-judicial enforcement is permitted under the law governing the creation of the security, it would also be available to the

secured creditor in the State where the latter has to enforce its security, even if it is not generally allowed under the domestic law of that State.

26. An approach based on the reasonable expectations of the parties would suggest a rule referring enforcement issues to the law governing the creation of the security right. This solution would also avoid separating the remedies from the nature of the rights conferred by a security. Such a separation is not evident where the remedies are closely linked to the attributes of the security (for instance, the remedies of a conditional seller may be viewed as stemming from the fact that it has remained the legal owner of the goods). To the extent that the conflict-of-laws rule on priority issues would be the same as for creation and publicity, another benefit of the law regarding creation of the security and the law governing enforcement coming from the same regime would be that priority and enforcement issues would be subject to the same law.

27. A third option is to adopt a rule whereby the law governing the contractual relationship of the parties would also govern enforcement matters. This would often correspond to their expectations and, in many instances, would also coincide with the law applicable to the creation of the security right since that law is often selected as also being the law of the contract. However, under this approach, parties would then be free to select, for enforcement issues, a law other than the law of the forum or the law governing creation, publicity and (or) priority. This solution would be disadvantageous to third parties that might have no means to ascertain the nature of the remedies that could be exercised by a secured creditor against the property of their common debtor.

28. Therefore, referring enforcement issues to the law governing the contractual relationship of the parties would necessitate exceptions designed to take into account the interests of third parties, as well as the mandatory rules of the forum, or of the law governing validity and publicity. Procedural matters would, in any case, need to be governed by the law of the forum. As a result, the various enforcement issues would be treated differently.

## **5. The impact of insolvency on conflict-of-laws rules**

29. As pointed out in the Insolvency Chapter (A/CN.9/WG.VI/WP.9/Add.6, para. ...), in general a security right effective against the grantor and third parties outside of insolvency should continue to be effective in insolvency proceedings. Similarly, the occurrence of insolvency should not displace the conflict-of-laws rules applicable to the creation, the publicity and, subject to some exceptions, the priority of a security right.

### **[Note to Working Group**

*Consideration might also be given to the impact of insolvency on any conflict-of-laws rule for enforcement measures, and whether this Guide should deal with this issue or whether it is more appropriately dealt with in the Guide on Insolvency.]*

## B. Summary and recommendations

30. The creation, publicity and priority of a possessory security right over tangible property, money, negotiable documents of title and negotiable instruments are governed by the law of the State in which the encumbered asset is located.

31. The creation, publicity and priority of a non-possessory security right over intangible property are governed by the law of the State in which the grantor is located.

32. With respect to a non-possessory security right over tangible property, the following alternatives may be considered:

### Alternative 1

The creation and publicity of a non-possessory security right over tangible property are governed by the law of the State in which the grantor is located, but the priority of such a security right is governed by the law of the State in which the encumbered asset is located.

### Alternative 2

The creation, publicity and priority of a non-possessory security right over tangible property are governed by the law of the State in which the encumbered asset is located, except for mobile goods where such issues are governed by the law of the State in which the grantor is located.

33. If a State adopts alternative 2, it might wish to consider an additional rule for goods in transit which would provide that a security right over such goods may be validly created and publicized under the law of the place of destination provided that they are moved to that place within a certain time limit.

34. The above rules do not specifically refer to proceeds, on the assumption that the conflict-of-laws rules for proceeds should, in principle, be the same as those applicable to a security right initially obtained over the same type of property.

35. A security right validly created and publicized under the law of a State other than the enacting State continues to be valid and publicized in the enacting State after the connecting factor changes to the enacting State, if the publicity requirements of the enacting State are complied with within a specified grace period. This rule would imply that creation issues continue to be governed by the initial governing law while publicity (and priority to the extent that priority is governed by the same law as publicity) would be governed, after the change, by the law of the enacting State.

36. With regard to the law applicable to enforcement issues, the following alternatives may be considered:

### Alternative 1

Substantive matters affecting the enforcement of the rights of a secured creditor are governed by the law of the State where enforcement takes place.

**Alternative 2**

Substantive matters affecting the enforcement of the right of a secured creditor are governed by the law governing the creation [and the priority] of the security right.

**Alternative 3**

Substantive matters affecting the enforcement of the rights of a secured creditor are governed by the law governing the contractual relationship of the creditor and the grantor, with the exception of [...].

37. The law may provide expressly that the occurrence of insolvency does not displace the conflict-of-laws rules applicable to the creation and publicity of a security right. With respect to priority, the law determined pursuant to the applicable conflict-of-laws rules should continue to govern, subject to the mandatory provisions of the insolvency regime of the enacting State.



**Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fourth session**

ADDENDUM

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## **XI. Transition issues**

### **A. General remarks**

#### **1. The need for transition provisions**

1. The rules embodied in new secured transactions legislation will be different from the rules in the law predating the legislation. Those differences will have an obvious impact on secured transactions that take place after the new legislation is enacted. The effect of the new legislation on existing transactions entered into prior to the new legislation must also be considered. In light of the differences between the old and new legal regimes and the continued existence of transactions and security rights created under the old regime, it will be important for the success of the new legislation that it contain fair and efficient rules governing the transition from the old rules to the new rules. In this context, two related, but distinct, issues must be addressed. First, the new legislation should provide the date as of which it will have legal effect (the “effective date”). Second, the new legislation should also set forth the extent, if any, to which, after the effective date, the new legislation

applies to issues relating to transactions or security rights that existed before the effective date.

2. A number of factors require consideration in determining the effective date of the legislation. Prompt realization of the economic advantages of new legislation must be balanced against the need to avoid causing instability in, or disruption of, the markets that will be governed by new legislation and in allowing the market participants adequate time to prepare for conducting transactions under the new legislation, which may be significantly different from the prior law. Accordingly, the State may conclude that the effective date of new legislation should be some period of time after the enactment of the new legislation in order for these markets and their participants to adjust their transactions to the new rules. In determining the effective date, States might consider: the impact of the effective date on credit decisions; maximization of benefits to be derived from the new legislation; the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure; the harmonization of the new secured transaction legislation with other legislation; constitutional limits to the retroactive effect of new legislation; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

3. As debts that are secured by rights in the grantor's property are often payable over a period of time, it is likely that there will be many rights created before the effective date that will continue to exist on and after the effective date, securing debts that are not yet paid. Therefore, as noted above, another important decision that must be made with respect to any new legislation is the extent, if any, to which the new legislation will govern issues relating to transactions entered into prior to the effective date.

4. One approach would be for the new legislation to apply prospectively only and, therefore, not to govern any transactions entered into prior to the effective date. While there is a certain logical appeal in such a solution, especially with respect to issues that arise between the grantor and the secured creditor, such an approach would create significant problems, especially with respect to priorities. Foremost among those problems would be the necessity of resolving priority disputes between a secured creditor which obtained its security right prior to the effective date and a competing secured creditor which obtained its security right in the same property after the effective date. Because priority is a comparative concept, and the same priority rule must govern the two rights that are being compared, it is not possible for the old rules to govern the priority of the interest of the pre-effective date creditor and the new rules to govern the priority of the interest of the post-effective date creditor. Determining which priority rule to apply to a such priority dispute is not without difficulty. Applying the old rules to such priority disputes would essentially delay the effectiveness of some of the most important aspects of the new legislation, with the result that significant economic benefits of the new legislation could be deferred for a substantial period. On the other hand, applying the new rules to such priority disputes might unfairly prejudice parties which relied on the old law and might also provide an incentive for such parties to object to the new legislation or advocate an unduly delayed effective date.

5. Alternatively, greater certainty and earlier realization of the economic benefits of the new legislation could be promoted by applying the new legislation to all

transactions as of the effective date, but with such “transition provisions” as are necessary to assure an effective transition to the new regime without loss of pre-effective date priority status. Such an approach would avoid the problems identified above and would otherwise fairly and efficiently balance the interests of parties which complied with the old law with the interests of parties which comply with the new law.

## **2. Issues to be addressed by transition provisions**

### **a. Generally**

6. Because many security rights created before the effective date will continue to exist after the effective date, and may come into conflict with security rights created after the effective date, it is important for the new legislation to provide clear transition provisions to determine the extent to which the rules in the new legislation will apply to those pre-existing rights. These transition provisions should appropriately address both the settled expectations of parties and the need for certainty and predictability in future transactions. The transition provisions must address the extent to which the new rules will apply, after the effective date, as between the parties to a transaction creating a security right before the effective date. They must also address the extent to which the new rules will apply, after the effective date, to resolve priority disputes between holder of a security right and a competing claimant, when either the security right, or the interest of the competing claimant, was created before the effective date.

### **b. Effectiveness of pre-effective date rights as between the parties**

7. When a security right has been created before the effective date of new legislation, two questions arise regarding the effectiveness of that right between the grantor and the creditor. The first is whether a right that was not effective between the parties under old law, but would be effective if the new law applied should become effective on the effective date of the new law. The second question is whether a right that was effective between the parties under the old law but would be ineffective if the new law applied should become ineffective between the parties on the effective date of the new law. Such an approach would recognize that the new legislation’s rules for effectiveness between the parties comprise the State’s most current policy choices as to the requirements for effectiveness, taking into account the protections of the transacting parties, and that as a general matter the parties themselves would presumably favour effectiveness of a transaction that they entered into. With respect to the first question, consideration should be given to making the right effective as of the effective date of the new law. With respect to the second question, a transition period might be created during which the security right would remain effective between the parties, so that the creditor could take the necessary steps during the transition period to make the right effective under the new law. At the expiration of the transition period, the right would become effective between the parties under the new law.

### **c. Effectiveness of pre-effective date rights as against third parties**

8. Different issues are raised as to the effectiveness against third parties of a right created before the effective date. As new legislation will embody public policy regarding the proper steps necessary to make a right effective against third parties, it

is preferable for the new rules to apply to the greatest extent possible. It may, however, be unreasonable to expect a creditor whose right was effective against third parties under the previous legal regime to comply immediately with any additional requirements of the new law. The expectation would be especially onerous for institutional creditors, which would be required to comply with the additional requirements of the new law simultaneously for large numbers of pre-effective date transactions. A preferable approach would be for a security right that was effective against third parties under the previous legal regime but would not be effective under the new rules, should remain effective for a reasonable period of time (as set forth in the new law) so as to give the creditor time to take the necessary steps under the new law. At the expiration of the transition period, the right would become ineffective against third parties unless it had become effective against third parties under the new law.

9. If the right was not effective against third parties under the previous legal regime, but is nonetheless effective against them under the new rules, the right should be effective against third parties immediately upon the effective date of the new rules. Once again, the presumption is that the parties intended effectiveness as between them, and third parties are protected to the full extent of the new rules.

#### **d. Priority disputes**

10. An entirely different set of questions arises in the case of priority disputes because such disputes necessarily involve applying one set of rules to two (or more) different rights created at different times. A legal system cannot simply provide that the priority rule in effect at the time when a right was created governs priority with respect to that right. Rather, there must be rules that address each of the following situations: (i) where both rights are created after the effective date of the new legislation, (ii) where both rights are created before the effective date, and (iii) where one right is created before the effective date and the other right is created after the effective date.

11. The easiest situation, of course, is a priority dispute between two parties both of whose rights were created after the effective date of the new legislation. In that situation, it is obvious that the priority rules in the new legislation should be applied to resolve that dispute.

12. Conversely, if both of the competing rights were created before the effective date of the new legislation (and, accordingly, the relative priority of the two competing rights in the encumbered assets was established before the effective date of new rules) and, in addition, nothing (other than the effective date having occurred) has happened that would change that relative priority, stability of relationships suggests that the priority established before the effective date should not be changed. If, however, something occurs after the effective date that would have had an effect on priority even under the previous legal regime, there is less reason to continue to utilize old rules to govern a dispute that has been changed by an action that took place after the effective date. Therefore, there is a much stronger argument for applying the new rules to such a situation.

13. The most difficult transition situation involves a priority dispute between one party whose right was established before the effective date and another party whose right was established after the effective date. In such a case, while it is preferable to

have the new rules govern eventually, it is appropriate to provide a transition rule protecting the status of the creditor whose right was acquired under the old regime while that creditor takes whatever steps are necessary to maintain protection under the new regime. If those steps are taken within the requisite time, the new legislation should provide that creditor with priority to the same extent as would have been the case had the new rules been effective at the time of the original transaction and those steps had been taken at that time.

**e. Disputes before a court or arbitral tribunal**

14. When a dispute is in litigation (or a comparable dispute resolution system) at the effective date, the rights of the parties have sufficiently crystallized so that the effectiveness of a new legal regime should not change the outcome of that dispute. Therefore, such a dispute should not be resolved by application of the new legal regime.

**B. Summary and recommendations**

15. New secured transactions legislation should specify a date, subsequent to the enactment of the legislation, as of which it will enter into force (the “effective date”).

16. A State might take into account the following considerations in determining the effective date: the impact of the effective date on credit decisions; maximisation of benefits to be derived from the new legislation; the necessary regulatory, institutional, educational and other arrangements or infrastructure improvements to be made by the State; the status of the pre-existing law and other infrastructure; the harmonisation of the new secured transaction legislation with other legislation; the content of constitutional rules with respect to pre-effective date transactions; and standard or convenient practice for the entry into force of legislation (e.g. on the first day of a month).

17. The new legislation should provide a period of time after the effective date (the “transition period”), during which creditors with security rights effective against the grantor and third parties under the previous regime may take steps to assure that those rights are effective against the grantor and third parties under the new legislation. If those steps are taken during the transition period, the legislation should provide that the effectiveness of the creditor’s rights against those parties is continuous.

18. The new legislation should provide clear rules for resolving: (i) which law applies to the priority between post-effective date rights; (ii) which law applies to the priority between pre-effective date rights; (iii) which law applies to the priority between pre-effective date and post-effective date rights.

19. The new legislation should provide that priority between post-effective date rights is governed by the new legislation.

20. The new legislation should provide generally that priority between pre-effective date rights is governed by the former legal regime. The legislation might also provide, however, that application of those former rules will occur only if no event occurs after the effective date that would have changed the priority under the former regime. If such an event occurs, the new legislation would determine priority.

21. With respect to priority between pre-effective date rights and post-effective date rights, the new legislation should apply as long as the holder of a pre-effective date right may, during the transition period, ensure priority under the new legislation by taking whatever steps are necessary under the new legislation. During the transition period, the priority of the pre-effective date right should continue as though the new legislation had not become effective. If the appropriate steps are taken during the transition period, the holder of the pre-effective date right should have priority to the same extent as would have been the case had the new rules been effective at the time of the original transaction and those steps had been taken at that time.

22. When a dispute is in litigation (or a comparable dispute resolution system) at the effective date of the new legislation, the rights of the parties should not be resolved by application of the new legal regime.

**C. Report of Working Group V (Insolvency Law) and Working Group VI  
(Security Interests) on the work of their second joint session  
(New York, 26 and 29 March 2004)  
(A/CN.9/550) [Original: English]**

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**D. Report of the Working Group on Security Interests on the work of its  
fifth session (New York, 22-25 March 2004)**

**(A/CN.9/549) [Original: English]**

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## I. Introduction

1. At its present session, the Working Group continued its work on the development of “an efficient legal regime for security rights in goods involved in a commercial activity”.<sup>1</sup> The Commission’s decision to undertake work in the area of secured credit law was taken in response to the need for an efficient legal regime that would remove legal obstacles to secured credit and could thus have a beneficial impact on the availability and the cost of credit.<sup>2</sup>

2. At its thirty-third session (2000), the Commission discussed a report prepared by the secretariat on issues to be addressed in the area of secured credit law (A/CN.9/475). At that session, the Commission agreed that secured credit law was an important subject and had been brought to the attention of the Commission at the right time, in particular in view of its close link with the work of the Commission on insolvency law. It was widely felt that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade. It was also widely felt that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries, and in the share such parties had in the benefits of international trade. A note of caution was struck, however, in that regard to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States.

<sup>1</sup> *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17 (A/56/17)*, para. 358.

<sup>2</sup> *Ibid.*, *Fifty-fifth Session, Supplement No. 17 (A/55/17)*, para. 455, and *Fifty-sixth Session, Supplement No. 17 (A/56/17)*, para. 347.

Furthermore, it was stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, would be advisable.<sup>3</sup>

3. At its thirty-fourth session (2001), the Commission considered another report prepared by the secretariat (A/CN.9/496) and agreed that work should be undertaken in view of the beneficial economic impact of a modern secured credit law. It was stated that experience had shown that deficiencies in that area could have major negative effects on a country's economic and financial system. It was also stated that an effective and predictable legal framework had both short- and long-term macroeconomic benefits. In the short term, namely, when countries faced crises in their financial sector, an effective and predictable legal framework was necessary, in particular in terms of enforcement of financial claims, to assist banks and other financial institutions in controlling the deterioration of their claims through quick enforcement mechanisms and to facilitate corporate restructuring by providing a vehicle that would create incentives for interim financing. In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential.<sup>4</sup> As to the form of work, the Commission considered that a model law would be too rigid and noted the suggestions made for a set of principles with a legislative guide that would include legislative recommendations.<sup>5</sup>

4. At its first session (New York, 20-24 May 2002), the Working Group considered chapters I to V and X (A/CN.9/WG.VI/WP.2 and Add.1-5 and 10) of the first preliminary draft guide on secured transactions, prepared by the secretariat. At that session, the Working Group requested the secretariat to prepare revised versions of those chapters (see A/CN.9/512, para. 12). At that session, the Working Group also considered suggestions for the presentation of modern registration systems in order to provide the Working Group with information necessary to address concerns expressed with respect to registration of security rights in movable property (see A/CN.9/512, para. 65). At the same session, the Working Group agreed on the need for coordination with Working Group V (Insolvency Law) on matters of common interest and endorsed the conclusions of Working Group V with respect to those matters (see A/CN.9/512, para. 88).

5. At its thirty-fifth session (2002), the Commission considered the report of the first session of the Working Group (A/CN.9/512). It was widely felt that the legislative guide represented a valuable opportunity for the Commission to assist States in adopting modern secured transactions legislation, which was generally thought to be a necessary, albeit not sufficient in itself, condition for increasing access to low-cost credit, thus facilitating the cross-border movement of goods and services, economic development and ultimately friendly relations among nations. In that connection, the Commission noted with satisfaction that the project had attracted the attention of international, governmental and non-governmental

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<sup>3</sup> *Ibid.*, *Fifty-fifth Session, Supplement No. 17 (A/55/17)*, para. 459.

<sup>4</sup> *Ibid.*, *Fifty-sixth Session, Supplement No. 17 (A/56/17)*, para. 351.

<sup>5</sup> *Ibid.*, para. 357.

organizations and that some of those took an active part in the deliberations of the Working Group. At that session, the Commission also felt that the timing of the Commission's initiative was most opportune both in view of the relevant legislative initiatives under way at the national and international levels and in view of the Commission's own initiative in the field of insolvency law. After discussion, the Commission confirmed the mandate given to the Working Group at its thirty-fourth session to develop an efficient legal regime for security rights in goods, including inventory. The Commission also confirmed that the mandate of the Working Group should be interpreted widely to ensure an appropriately flexible work product, which should take the form of a legislative guide.<sup>6</sup>

6. At its second session (Vienna, 17-20 December 2002), the Working Group considered chapters VI, VII and IX (A/CN.9/WG.VI/WP.2 and Add.6, 7 and 9) of the first preliminary draft guide on secured transactions, prepared by the secretariat. At that session, the Working Group requested the secretariat to prepare revised versions of those chapters (see A/CN.9/531, para. 15). In conjunction with that session and in accordance with suggestions made at the first session of the Working Group (see A/CN.9/512, para. 65), an informal presentation of the registration systems of security rights in movable property of New Zealand and Norway was held. Immediately before that session, Working Groups V (Insolvency Law) and VI (Security Interests) held their first joint session (Vienna, 16-17 December 2002), during which the revised version of former chapter X (new chapter IX; A/CN.9/WG.VI/WP.6/Add.5) on insolvency was considered. At that session, the secretariat was requested to prepare a revised version of that chapter (see A/CN.9/535, para. 8).

7. At its third session (New York, 3-7 March 2003), the Working Group considered chapters VIII, XI and XII of the first preliminary draft guide on secured transactions (A/CN.9/WG.VI/WP.2/Add.8, A/CN.9/WG.VI/WP.2/Add.11 and A/CN.9/WG.VI/WP.2/Add.12) and chapters II and III (paras. 1-33) of the second version of the draft guide (A/CN.9/WG.VI/WP.6/Add.2 and A/CN.9/WG.VI/WP.6/Add.3) and requested the secretariat to prepare revised versions (A/CN.9/532, para. 13).

8. At its thirty-sixth session in 2003, the Commission had before it the reports of Working Group VI (Security Interests) on the work of its second and third sessions (A/CN.9/531 and A/CN.9/532), as well as the report of the first joint session of Working Group V and VI (A/CN.9/535). The Commission noted with appreciation the progress made by the Working Group in its work.<sup>7</sup>

9. At its fourth session (Vienna, 8-12 September 2003), the Working Group considered chapters IV (Creation), IX (Insolvency), I (Introduction), II (Key Objectives) and paragraphs 1 to 41 of chapter VI (Priority) and requested the secretariat to prepare revised versions of those chapters (see A/CN.9/543, para. 15).

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<sup>6</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, paras. 202-204.

<sup>7</sup> *Ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, paras. 215-222.

## II. Organization of the session

10. The Working Group, which was composed of all States members of the Commission, held its fifth session in New York from 22 to 25 March 2004. The session was attended by representatives of the following States members of the Commission: Austria, Burkina Faso, Cameroon, Canada, China, Colombia, Fiji, France, Germany, India, Italy, Japan, Kenya, Mexico, Russian Federation, Sierra Leone, Spain, Sudan, Sweden, Thailand, Uganda and United States of America.

11. The session was attended by observers from the following States: Argentina, Australia, Belarus, Belgium, Cuba, Czech Republic, Ghana, Holy See, Indonesia, Ireland, Kuwait, Libyan Arab Jamahiriya, Madagascar, Mongolia, Netherlands, Nigeria, Oman, Peru, Philippines, Poland, Qatar, Republic of Korea, Serbia and Montenegro, Switzerland, Turkey and Viet Nam.

12. The session was also attended by observers from the following national or international organizations: (a) organizations of the United Nations system: International Monetary Fund (IMF), the World Bank, World Intellectual Property Organization (WIPO); (b) intergovernmental organizations: Asian-African Legal Consultative Organization (AALCO), European Bank for Reconstruction and Development (EBRD); (c) non-governmental organizations invited by the Commission: American Bar Association (ABA), Center for International Legal Studies (CILS), Centre pour la Recherche et l' Étude du Droit Africain Unifié (CREDAU), Commercial Finance Association (CFA), International Chamber of Commerce (ICC), International Federation of Insolvency Professionals (INSOL), International Insolvency Institute (III), International Law Institute (ILI), International Swaps and Derivatives Association (ISDA), International Working Group on European Insolvency Law, Max-Planck-Institute of Foreign and Private International Law, the European Law Student's Association (ELSA) and the Union Internationale des Avocats (UIA).

13. The Working Group elected the following officers:

*Chairman:* Kathryn Sabo (Canada)  
*Rapporteur:* Masami Nakashima (Japan)

14. The Working Group had before it the following documents: A/CN.9/WG.VI/WP.9 and Addenda 1 (Approaches to security), 2 (Publicity and filing), 3 (Priority), 4 (Pre-default rights and obligations), 7 (Conflict of laws) and 8 (Transition), as well as A/CN.9/WG.VI/WP.11 and Addenda 1 (Introduction and Key Objectives) and 2 (Creation).

15. The Working Group adopted the following agenda:

1. Election of officers.
2. Adoption of the agenda.
3. Preparation of a legislative guide on secured transactions.
4. Other business.
5. Adoption of the report.

### III. Deliberations and decisions

16. The Working Group considered chapters V (Publicity), VI (Priority) and X (Conflict of laws) of the draft Legislative Guide on Secured Transactions (hereinafter referred to as “the draft Guide”). The deliberations and decisions of the Working Group are set forth below in part IV. The secretariat was requested to prepare, on the basis of those deliberations and decisions, a revised version of the chapters of the draft Guide discussed at that session.

### IV. Preparation of a legislative guide on secured transactions

#### Chapter VI. Priority (A/CN.9/WG.VI/WP.9/Add.3, paras. 78-90)

17. The Working Group recalled that, at its fourth session, it had considered paragraphs 34-41 of chapter VI (see A/CN.9/543, paras. 103-120). However, in order to have a more focused discussion and make as much progress as possible within the current session, which was shorter by one day than normal sessions, the Working Group decided to skip the general remarks (A/CN.9/WG.VI/WP.9/Add.3, paras. 42-77) and to consider the summary and recommendations contained in chapter VI (A/CN.9/WG.VI/WP.9/Add.3, paras. 78-90).

#### Priority of possessory security rights (para. 82)

18. With respect to paragraph 82, which dealt with the priority of possessory security rights, it was agreed that it should be revised to state three rules. The first rule was that the priority of a possessory security right could be established by possession, control or filing, whichever occurred first. The second rule was that a secured creditor who established priority by one method could change to another method, without losing its original priority ranking as long as there was no gap in the continuity of filing, possession or control. The third rule was that, in order to protect the negotiability of certain assets (e.g. documents of title), a security right in such assets perfected by possession or control should have priority even over a security right that was perfected only by filing, even if the filing occurred first. With respect to the last rule, it was agreed that it should be revised to refer explicitly to specific assets with a degree of negotiability. Still, some doubt was expressed as to the appropriateness of such a rule on the grounds that it could undermine the certainty achieved by the first-to-file priority rule.

19. Subject to the changes to the recommendations contained in paragraph 82, the Working Group approved the essence of the recommendations contained in chapter VI, with the exception of the recommendations on title-based devices which it decided to place within square brackets. The secretariat was requested to revise the recommendations contained in paragraph 82 and to align the general remarks with the revised recommendations.

20. Recalling its discussion of fixtures at its fourth session (see A/CN.9/543, paras. 23-24), the Working Group also requested the secretariat to include in chapter VI a discussion and recommendations on conflicts of priority relating to fixtures. In response to a question as to the effect of subordination agreements in the case of the insolvency of the grantor, the Working Group noted that that was an issue for the second joint session of Working Groups V (Insolvency Law) and VI (Security Interests) (see A/CN.9/WG.V/WP.71, para. 7 (e)).

## **Chapter X. Conflict of laws (A/CN.9/WG.VI/WP.9/Add.7, paras. 30-37)**

21. The Working Group went on to discuss chapter X on the basis of the recommendations reflected in paragraphs 30 to 37.

### **A. Law applicable to possessory security rights over tangible property and to non-possessory security rights over intangible property (paras. 30 and 31)**

22. It was generally agreed that the essence of the recommendations reflected in paragraphs 30 and 31 was acceptable. As to the formulation of those recommendations, it was agreed that money and negotiable instruments should be reflected as types of tangible property and claims as types of intangible property. It was also agreed that the reference to the term “publicity” should be replaced by a reference to the term “effectiveness against third parties” as some States might not have a publicity system.

### **B. Law applicable to non-possessory security rights over tangible property (para. 32)**

23. With respect to the alternative recommendations contained in paragraph 32, which dealt with the law applicable to the creation, publicity (i.e. effectiveness against third parties) and priority of non-possessory security rights over tangible property, differing views were expressed. One view was that alternative 1 was preferable. It was stated that, by subjecting creation and effectiveness against third parties to the law of the grantor’s location, alternative 1 eliminated the risk of the application of multiple laws in the case of mobile goods, goods in transit and goods moved from one jurisdiction to another, as well as assets located in multiple jurisdictions. It was observed that, under such an approach, certainty with respect to the applicable law would be enhanced and transaction costs would be reduced. It was also said that, at the same time, by subjecting priority to the law of the location of the encumbered assets, alternative 1 did not upset the legitimate expectations of parties, such as buyers of encumbered assets or judgement creditors.

24. However, the prevailing view was that alternative 2 was preferable because it reflected the widely acceptable rule of the law of the location of the asset (*lex rei sitae*). It was stated that alternative 2 was the only rule acceptable with respect to title-based devices. It was also observed that alternative 1 was problematic since it subjected the creation and effectiveness of a security right against third parties to one law (the law of the grantor’s location) and priority to another law (the law of the asset’s location). In addition, it was said that alternative 1 could not be easily applied in jurisdictions that made no distinction among creation, effectiveness against third parties and priority. Moreover, it was observed that alternative 1 would place on parties and courts the burden and cost of having to apply two different laws.

25. After discussion, while it was suggested that both alternatives should be retained for further consideration, the Working Group decided to delete alternative 1. It was widely felt that harmonization of law, which was one of the main objectives of the draft Guide, would be better served if the draft Guide included clear recommendations without many alternatives. The Working Group also agreed that alternative 2 should be supplemented by a definition of the term “mobile goods” and by a reference to the point in time that was relevant for the determination of the location of the encumbered assets. As to the exception contained in alternative 2 with respect to security rights in mobile goods (the law of the grantor’s location), while some doubt was expressed, it was generally found to be acceptable on the assumption that the term “mobile goods” meant assets with respect to which there were no special registration systems such as those existing for aircraft, ships and similar assets.

**C. Law applicable to security rights over goods in transit (para. 33)**

26. As to the recommendation contained in paragraph 33 with respect to security rights in goods in transit, while it was generally agreed that a recommendation was necessary, some doubt was expressed as to whether an approach based on the law of the place of destination was the most appropriate one. It was suggested that other alternatives should also be considered, such as, for example, the law of the place in which the party holding an interest in the goods received a document of title relating to the goods.

**D. Law applicable to security rights in proceeds (para. 34)**

27. There was general agreement in the Working Group that the same law should apply to the priority of a security right, irrespective of whether the relevant assets were original encumbered assets or proceeds. However, differing views were expressed as to the law applicable to the creation of security rights in proceeds. One view was that that matter should be subject to the law governing the creation of the right in the original encumbered assets from which the proceeds arose. Another view was that the creation of security rights in proceeds should be subject to the law governing the creation of assets of the same type as proceeds. In the case of goods being original encumbered assets in State A and receivables being proceeds in State B, under the first view the creation of the right in proceeds would be subject to the law of State A, while under the second view, that matter would be subject to the law of State B. It was noted that both approaches were consistent with the United Nations Convention on the Assignment of Receivables in International Trade since they both referred priority issues to the law of the grantor’s (assignor’s in the terminology of the Convention) location.

**E. Law applicable to security rights in goods that were moved from one jurisdiction to another (para. 35)**

28. There was general agreement with the essence of the recommendation contained in paragraph 35 that, if goods were moved from State A to State B, creation issues would remain subject to the law of State A, while priority issues

would be subject to the law of State B and secured creditors with priority under the law of State A would preserve their priority provided that they perfected their right under the law of State B within a certain period of time after the goods were moved to State B. As to the formulation of paragraph 35, it was agreed that it needed to be revised so as to state that rule more clearly.

#### **F. Law applicable to the enforcement of security rights (para. 36)**

29. There was both support and criticism in the Working Group for all of the alternatives contained in paragraph 36. In support of alternative 1, it was stated that an approach based on the law of the place of enforcement would reflect a generally acceptable rule. It was also observed that such an approach would result in the law of remedies being the same with the law applicable to procedural issues and, in many cases, with the law of the location of the assets. On the other hand, it was pointed out that alternative 1 could be subject to manipulation.

30. In support of alternative 2, it was said that the application of the law governing the creation of a security right would be consistent with the expectations of the parties and provide a stable rule. On the other hand, it was mentioned that alternative 2, applied with the *lex rei sitae* as the law governing the creation of a security right, would result, in the case of enforcement against assets in multiple jurisdictions, in the application of the law of all those jurisdictions. It was observed that the impact of such an approach could be minimized if alternative 2 were refined to refer to the law governing priority.

31. In support of alternative 3, it was pointed out that the law governing the contractual relationship between the creditor and the grantor would correspond to the parties' expectations but put at disadvantage third parties that had no means of ascertaining the nature of remedies of a secured creditor. It was also stated that, if an approach on the basis of alternative 3 were adopted, exceptions should be introduced to protect interests of third parties, such as employees for wages and the State for taxes. In response, it was observed that a limitation to the application of the applicable law so as to preserve the public policy or mandatory rules of the forum State was inherent in all alternatives.

32. With respect to all of the alternatives in paragraph 36, it was mentioned that, while the term "substantive matters" was used to draw a distinction from procedural matters and, in any case, their characterization was left to the law of the forum, it still needed to be further clarified. It was also stated that the alternatives should be compared and analysed on the basis of their relevant costs and benefits. For example, if alternative 3 were to be preferred and resulted in the application of a law that allowed self-help remedies, the result should be evaluated on the basis of its impact on the availability and the cost of credit. The suggestion was also made that the rule implied in all alternatives, namely, that procedural matters should be governed by the law of the State in which enforcement was sought, should be stated explicitly.

33. After discussion, the Working Group requested the secretariat to revise the alternatives in paragraph 36 to take into account the views expressed and the suggestions made.



## **G. Law applicable to the enforcement of security rights in the case of insolvency (para. 37)**

34. It was generally agreed that the commentary and the recommendations in chapter X with respect to the law applicable to the enforcement of a security right in the case of insolvency should be comprehensive and self-standing but aligned with the relevant discussion and recommendations in the draft Guide on Insolvency Law. The Working Group found the principles contained in the current text of the draft Guide on Insolvency Law (see A/CN.9/WG.V/WP.72, paras. 179-181) to be generally acceptable. In particular, it was agreed that the commencement of insolvency proceedings should not displace the general, pre-insolvency conflict-of-laws rules applicable to the creation and effectiveness of a security right against third parties. It was also agreed that commencement of insolvency proceedings should not displace the law applicable to priority of security rights, except to the extent explicitly provided in insolvency law. In addition, it was agreed that commencement could displace the rules applicable to the enforcement of security rights since enforcement should be subject to the insolvency law of the State in which the insolvency proceedings were commenced. With respect to that principle, the view was expressed that it should apply to the enforcement of security rights in assets located in the State in which insolvency proceedings were commenced but not to the enforcement of rights in assets in other jurisdictions. In response, it was observed that that issue was an issue of insolvency law for the draft Guide on Insolvency Law to address.

## **Chapter V. Publicity (A/CN.9/WG.VI/WP.9/Add.2)**

35. The Working Group focused on the summary and recommendations contained in chapter V (paras. 97-103). At the outset, it was agreed that while the principle of publicity was common to most legal systems, it had different degrees and was understood in various ways. It was stated that, as the draft Guide was based on a distinction between creation of a security right as between the parties to the security agreement and its effectiveness against third parties, it was important for publicity to be analysed in terms of the steps necessary to render a security right effective as against third parties (or in the sense of ensuring that third parties were not misled by the grantor's apparent ownership). In that connection, it was observed that the economic benefits (to all parties involved) of providing certainty and predictability as to the rights of third parties could be usefully discussed in the draft Guide. After discussion, the Working Group agreed that the draft Guide should recommend that publicity should be a pre-condition of the effectiveness of security rights against third parties and of ensuring the protection of third parties. The Working Group went on to consider the various modes of publicity in the order they were discussed in chapter V.

### **A. Dispossession (paras. 7-16)**

36. It was generally agreed that transfer of possession of the encumbered assets to the secured creditor was a good way to alert third parties that the grantor no longer had unencumbered title. It was also agreed that to achieve that result, dispossession

of the grantor had to be real and not just fictive. In addition, it was agreed that transfer of possession to the secured creditor could not work well in the case of intangibles and in cases where the grantor needed to retain possession of the assets to generate the income necessary to repay the loan.

#### **B. Notification and control (paras. 17-23)**

37. It was stated that notification of the debtor of a receivable was a method of publicizing the creation of a security right in the receivable to the extent that third parties could find out from that debtor whether the receivable had been encumbered. However, it was agreed that such notification was not an effective way of publicity since debtors were not obliged to provide to third parties any information or accurate information and, in many transactions, notification was not desirable.

38. As to the notion of “control”, a number of concerns were expressed. One concern was that it was new and was not universally understood in the same way. It was observed, for example, that placing the account in the name of the secured creditor was treated in many jurisdictions as an assignment rather than as a transfer of control over the account. Another concern was that, for no apparent reason, deposit accounts were treated differently from receivables. Yet another concern was that, without a discussion of other methods of publicizing security rights in deposit accounts, the discussion of control was difficult to follow. After discussion, it was agreed that the discussion of control and security rights in deposit accounts should be revised to address those concerns.

#### **C. Registration in title-based registries ( paras. 24-31)**

39. It was agreed that notations on title certificates or registration in title registries were acceptable modes of publicity.

#### **D. Registration in secured transactions registries (paras. 32-33)**

40. It was stated that registration in a secured transactions registry could involve registration of the transaction document or a notice about the transaction. It was also observed that States interested in introducing a comprehensive secured transactions law with a view to developing competitive financial markets should establish a single, centralized secured transactions registry for publicizing notices with respect to all types of security right in all types of asset to enable third parties to assess their priority risk with greater certainty and predictability. In addition, it was pointed out that it was necessary to coordinate registration in secured transactions registries and in asset-specific registries in order to ensure the efficient operation of both.

41. While the view was expressed that registration of a notice in a secured transactions registry might inadvertently increase transaction costs, the prevailing view was that such registration could provide the certainty and predictability necessary for creditors to assess the relevant risks in a reliable way and thus have a positive impact on the availability and the cost of credit.

42. It was stated that publicity was a generally acceptable principle of secured transactions law and was intended to provide protection for third parties. Disposition of the grantor, notification of the debtor of a receivable, transfer of control over an intangible, such as a deposit account, and registration in a secured transactions registry were mentioned as being among the modes of publicity prevailing in various legal systems. In addition, it was pointed out that there was an economic need to facilitate the granting of non-possessory security rights and that publicity of security rights by registration was the most effective mode of publicity for such rights. Moreover, it was said that, if there were other effective modes of publicity, they should be mentioned and their relative advantages and disadvantages should be discussed in the draft Guide. In that connection, it was stated that the disadvantages of secured transactions registries should also be discussed. Examples of such disadvantages that were mentioned included: potential cost, time and effort involved; and failure of the registry to protect the secured creditor in cases where the grantor was not the owner or where the asset did not exist. It was also observed that, instead of enhancing credit, registries could lead to new bureaucracy and, therefore, create impediments to credit. In response, it was said that registries would not necessarily create bureaucracy if they were structured in the appropriate way as recommended in the draft Guide and, quite to the contrary, could result in economic efficiency.

43. On the basis of the broad support expressed in the discussion for secured transactions registries and after having noted the objections and concerns expressed, the Working Group decided that the draft Guide should include a recommendation that registration in a secured transactions registry was an acceptable mode of publicity and went on to consider the particular aspects of such registration.

#### **E. Notice v. document registration (paras. 34-37)**

44. It was agreed that the draft Guide should include a recommendation that registration of a notice was preferable to registration of the document of a transaction. It was widely felt that notice registration simplified the registration process and minimized administrative and other costs and burdens.

#### **F. Asset v. grantor indexing (paras. 38-42)**

45. It was agreed that the draft Guide should include a recommendation for a grantor-based index. It was stated that such an index facilitated registration of security rights in all of the grantor's present and after-acquired assets or in generic categories of assets through a single registration. With respect to uniquely identifiable assets, it was agreed that reference should be made to registration in asset-specific registries. However, it was widely felt that asset-specific registries needed to be coordinated with secured transactions registries so that a search in one registry would reveal registration in the other registry as well. Otherwise, third parties would need to search in both registry systems. In addition, it was agreed that a priority rule needed to be introduced to deal with priority conflicts between rights registered in the secured transactions registry and rights registered in the asset-specific registry.

### **G. Content of registered notice (paras. 43-53)**

46. There was general agreement in the Working Group that the recommended contents of a registered notice should be the identification of the grantor, the identification of the secured creditor and a general description of the encumbered assets. It was observed that limiting the content of the notice to the necessary information would maximize efficiency and minimize cost. On the other hand, the concern was expressed that a notice with limited data might not provide sufficient protection to third parties.

47. Noting that the identification criteria might vary from State to State and that it would not be appropriate for the draft Guide to prescribe the criteria to be used, the Working Group agreed to recommend that the criteria used be simple and clearly stated in the secured transactions law. The suggestion was also made that the commentary should state that a registry should provide a facility for updating identification details of the parties, in the event that they might change as a result of a name change, a merger or sale of business, or an assignment of the security right.

48. Differing views were expressed as to whether the registered notice should include a statement of the maximum value of the secured obligation. One view was that such an approach would allow the grantor to utilize the remaining value of its assets to obtain credit from another lender. Another view was that such a requirement would result in difficulties in calculating the amount to be secured and inflated calculations. After discussion, the Working Group decided that the matter needed to be discussed in the draft Guide but no recommendation should be made, at least at the current stage.

49. Differing views were also expressed as to whether there should be an obligation on the part of the secured creditor on record to respond to a demand for information by certain third parties. One view was that the secured creditor should be obliged to respond to such requests for information by parties that had an interest but no independent way to evaluate their claims against the grantor (unsecured creditors, insolvency administrator, co-owners of encumbered assets). It was stated that such an obligation could be introduced subject to the grantor's authorization who would have an interest in providing information to a potential lender. Another view was that the imposition of such an obligation should not be recommended. It was observed that interested third parties had a variety of sources of information at their disposal and that the system needed to be simple. After discussion, the Working Group agreed that the draft Guide needed to discuss that matter but no recommendation should be made, at least at the current stage.

50. The Working Group agreed that the draft Guide should include further discussion with respect to discharge, amendment and correction of notices.

### **H. Duration of registration (paras. 56-58)**

51. The Working Group agreed that no recommendation should be made with respect to the duration of registration. It was stated that the duration of registration depended on a number of factors (e.g. technological advancement and ease to expunge notices from the record or to make multiple registrations) on which States

differed. At the same time, the Working Group agreed that the draft Guide should provide the national legislator with sufficient guidance as to the possible approaches and their relative merits. In that connection, in addition to fixed duration and duration selected by the parties, two approaches were mentioned, namely registration with an indefinite duration and registration with a duration selected by the parties but with a maximum limit set by law.

52. In support of registration with an indefinite duration, it was stated that it would simplify registration without undue prejudice to the rights of the grantor, who could always request the removal of a notice from the public record. It was also observed that such an approach would encourage long-term credit transactions. On the other hand, it was said that such an approach would inappropriately place on the grantor the burden of having to take action in cases where the secured creditor failed to remove a notice from the record. In support of selection of the desired term by the parties up to a maximum time limit, it was stated that it combined the flexibility required for parties to meet their needs with the necessary protection of the grantor.

#### **I. Technological considerations (paras. 59-61)**

53. The Working Group agreed that the recommendation with respect to technological considerations should be that “the registration and searching process should be simple, transparent and as accessible as possible”. It was also suggested that reference should be made to the efficiency of a computerized registry system.

#### **J. Liability for system error (paras. 62-64)**

54. With respect to liability for system error, it was agreed that the draft Guide should recommend that the matter be addressed clearly in legislation without prescribing a uniform solution for all States, which might not be possible in view of the different approaches of States to the issues of liability and sovereign immunity.

#### **K. Registration fees (para. 65)**

55. It was generally agreed that the draft Guide should include a strong recommendation for nominal registration fees to cover the cost of the system. It was widely felt that such an approach would encourage use of the system, while covering its capital and operational costs within a reasonable period of time.

#### **L. Privacy and confidentiality considerations (paras. 66-67)**

56. It was stated that, in the context of a public registration system, it was not appropriate to focus on confidentiality since the contents of a registered notice were part of the public record. On the other hand, it was observed that a balance needed to be struck between the need to ensure sufficient publicity and the need to protect confidential and private information. It was also said that data filed in a secured transactions registry should not be used as a commercial product for sale or as a way of obtaining a competitor’s client lists. After discussion, it was agreed that, without making a firm recommendation, the draft Guide should discuss that matter

in terms of the need to facilitate use of information only for the purpose it was collected and made available.

#### **M. Advance registration (paras. 68-70)**

57. It was agreed that the draft Guide should include a recommendation that advance registration (i.e. registration before the conclusion of the security agreement) should be possible. It was stated that advance registration permitted a lender to gain time in ensuring its priority position and thus facilitated transactions that might otherwise be impossible or more costly. It was also agreed that so-called “grace periods”, allowing a lender to file within a certain period of time after conclusion of an agreement and obtain priority as of that time rather than as of the time of registration undermined the certainty of the registration system and thus should be allowed only in very limited and clearly prescribed cases. In addition, it was agreed that, if no credit were extended after an advance registration and the secured creditor failed to expunge a notice from the public record, the grantor should have a right to do so through a summary administrative proceeding.

58. The Working Group also agreed that, as notice was not supposed to relate to a specific security agreement or security right, a single notice could cover successive security agreements.

#### **N. Qualifications on priority (paras. 71-73)**

59. With the exception of the point that registration did not prejudice the rights of buyers of encumbered assets in the ordinary course of business, which could be retained, it was agreed that the discussion of priority should be left to the chapter on priority.

#### **O. Registration and enforcement (paras. 74-75)**

60. It was agreed that, while the registration of notice of default and enforcement could be briefly mentioned, discussion should be left to the chapter on enforcement. Differing views were expressed as to the advisability of requiring registration of notice of default and enforcement.

#### **P. Registration of title and similar devices (paras. 76-83)**

61. The Working Group agreed to postpone consideration of the question of registration of title and similar devices until it had an opportunity to discuss the overall treatment of such devices in the draft Guide. Recalling the decision reached at its last session that transfer of title for security purposes should be treated as a security device for the purposes of creation and insolvency (see A/CN.9/543, para. 73), in the interest of consistency, the Working Group approved a recommendation that the same approach should be taken for the purposes of publicity.

62. In the context of its discussion of secured transactions registries, the Working Group heard a statement by the representative of the European Bank for Reconstruction and Development (EBRD) with respect to work of the EBRD towards a registry guide. The Working Group noted with interest the work of the EBRD and emphasized the importance of coordination with a view to providing comprehensive and consistent guidance to States.

#### **Q. Other modes of publicity (paras. 84-85)**

63. It was stated that modes of publicity other than those currently discussed in the chapter on publicity should also be considered. In addition, it was observed that the chapter should include a more detailed discussion of the relevant advantages and disadvantages of all the various systems with respect to publicity. Moreover, it was said that the terminology used in the chapter might need to be reconsidered to better reflect different understandings of the terms “publicity” and “registration”. In that context, it was noted that the Working Group had expressed a preference for neutral terminology that was not system-specific.

#### **R. Effectiveness of unpublicized security rights (paras. 86-96)**

64. It was stated that an unpublicized security right might have no effects against third parties or only limited effects against certain third parties, such as buyers of encumbered assets with knowledge of the existence of the security right and parties that received those assets as a gift. It was observed that the former approach had the advantage of simplicity and certainty. After discussion, the Working Group decided to recommend that an unpublicized security right should have no effects against third parties.

#### **V. Future work**

65. The Working Group noted that its sixth session was scheduled to be held from 27 September to 1 October 2004 in Vienna, those dates being subject to approval by the Commission at its thirty-seventh session to be held from 14 June to 2 July 2004 in New York. It was noted that, in view of the urgency in providing States with guidance in the area of secured transactions law, the Working Group should complete its work as soon as possible, perhaps by submitting the draft Guide to the Commission in 2005 for approval in principle and in 2006 for final approval.

**E. Report of the Secretary-General on the draft legislative guide on secured transactions, working paper submitted to the Working Group on Security Interests at its fifth session**

**(A/CN.9/WG.VI/WP.11 and Add.1-2) [Original: English]**

**A/CN.9/WG.VI/WP.11**

1. At its thirty-third session in 2000, the Commission considered a report of the Secretary-General on possible future work in the area of secured credit law (A/CN.9/475). At that session, the Commission agreed that security interests was an important subject and had been brought to the attention of the Commission at the right time, in particular in view of the close link of security interests with the work of the Commission on insolvency law. It was widely felt that modern secured credit laws could have a significant impact on the availability and the cost of credit and thus on international trade. It was also widely felt that modern secured credit laws could alleviate the inequalities in the access to lower-cost credit between parties in developed countries and parties in developing countries, and in the share such parties had in the benefits of international trade. A note of caution was struck, however, in that regard to the effect that such laws needed to strike an appropriate balance in the treatment of privileged, secured and unsecured creditors so as to become acceptable to States. It was also stated that, in view of the divergent policies of States, a flexible approach aimed at the preparation of a set of principles with a guide, rather than a model law, would be advisable. Furthermore, in order to ensure the optimal benefits from law reform, including financial-crisis prevention, poverty reduction and facilitation of debt financing as an engine for economic growth, any effort on security interests would need to be coordinated with efforts on insolvency law.<sup>1</sup>

2. At its thirty-fourth session in 2001, the Commission considered a further report by the Secretariat (A/CN.9/496). At that session, the Commission agreed that work should be undertaken in view of the beneficial economic impact of a modern secured credit law. It was stated that experience had shown that deficiencies in that area could have major negative effects on a country's economic and financial system. It was also stated that an effective and predictable legal framework had both short- and long-term macroeconomic benefits. In the short term, namely, when countries faced crises in their financial sector, an effective and predictable legal framework was necessary, in particular in terms of enforcement of financial claims, to assist the banks and other financial institutions in controlling the deterioration of their claims through quick enforcement mechanisms and to facilitate corporate restructuring by providing a vehicle that would create incentives for interim

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<sup>1</sup> *Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17 (A/55/17)*, para. 459.



financing. In the longer term, a flexible and effective legal framework for security rights could serve as a useful tool to increase economic growth. Indeed, without access to affordable credit, economic growth, competitiveness and international trade could not be fostered, with enterprises being prevented from expanding to meet their full potential.<sup>2</sup>

3. While some concerns were expressed with respect to the feasibility of work in the field of secured credit law, the Commission noted that those concerns were not widely shared and went on to consider the scope of work.<sup>3</sup> It was widely felt that work should focus on security interests in goods involved in a commercial activity, including inventory. It was also agreed that securities and intellectual property should not be dealt with. As to intellectual property, it was stated that there was less need for work in that area, the issues were extremely complex and any efforts to address them should be coordinated with other organizations, such as the World Intellectual Property Organization (WIPO).<sup>4</sup> As to the form of work, the Commission considered that a model law might be too rigid and noted the suggestions made for a set of principles with a legislative guide that would include, where feasible, model legislative provisions.<sup>5</sup>

4. After discussion, the Commission decided to entrust a working group with the task of developing “an efficient legal regime for security rights in goods involved in a commercial activity, including inventory, to identify the issues to be addressed, such as the form of the instrument, the exact scope of the assets that can serve as collateral ...”.<sup>6</sup> Emphasizing the importance of the matter and the need to consult with representatives of the relevant industry and practice, the Commission recommended that a two- to three-day colloquium be held.<sup>7</sup>

5. At its first session (New York, 20-24 May 2002), Working Group VI (Security Interests) had before it a first, preliminary draft legislative guide on secured transactions, prepared by the Secretariat (A/CN.9/WG.VI/WP.2 and Add.1-12), a report on an UNCITRAL-CFA international colloquium, held in Vienna from 20 to 22 March 2002 (A/CN.9/WG.VI/WP.3), and comments by the European Bank for Reconstruction and Development (EBRD) (A/CN.9/WG.VI/WP.4). At that session, the Working Group considered chapters I to V and X (A/CN.9/WG.VI/WP.2 and Add.1-5 and 10), and requested the Secretariat to revise these chapters (A/CN.9/512, para. 12). At the same session, the Working Group agreed on the need to ensure, in cooperation with Working Group V (Insolvency Law), that issues relating to the treatment of security rights in insolvency proceedings would be addressed consistently with the conclusions of Working Group V on the intersection of the work of Working Group V and Working Group VI (see A/CN.9/512, para. 88 and A/CN.9/511, paras. 126-127).

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<sup>2</sup> Ibid., *Fifty-sixth Session, Supplement No. 17* (A/56/17), para. 351.

<sup>3</sup> Ibid., paras. 352-354.

<sup>4</sup> Ibid., paras. 354-356.

<sup>5</sup> Ibid., para. 357.

<sup>6</sup> Ibid., para. 358.

<sup>7</sup> Ibid., para. 359.

6. At its thirty-fifth session in 2002, the Commission had before it the report of Working Group VI (Security Interests) on the work of its first session (A/CN.9/512). The Commission expressed its appreciation to the Working Group for the progress made in its work. It was widely felt that, with that legislative guide, the Commission had a great opportunity to assist States in adopting modern secured transactions legislation, which was generally thought to be a necessary, albeit not sufficient in itself, condition for increasing access to low-cost credit, thus facilitating the cross-border movement of goods and services, economic development and ultimately friendly relations among nations.<sup>8</sup>

7. In addition, the feeling was widely shared that the timing of the Commission's initiative was most opportune both in view of the relevant legislative initiatives under way at the national and the international level and in view of the Commission's own initiative in the field of insolvency law. In that connection, the Commission noted with particular satisfaction the efforts undertaken by Working Group V (Insolvency Law) and Working Group VI towards coordinating their work on a subject of common interest such as the treatment of security interests in the case of insolvency proceedings. Strong support was expressed for such coordination, which was generally thought to be of crucial importance for providing States with comprehensive and consistent guidance with respect to the treatment of security interests in insolvency proceedings. The Commission endorsed a suggestion made to revise the insolvency chapter of the draft legislative guide on secured transactions in light of the core principles agreed by Working Groups V and VI (see A/CN.9/511, paras. 126-127 and A/CN.9/512, para. 88). The Commission stressed the need for continued coordination and requested the secretariat to consider organizing a joint session of the two Working Groups in December 2002.<sup>9</sup>

8. After discussion, the Commission confirmed the mandate given to the Working Group at its thirty-fourth session to develop an efficient legal regime for security interests in goods, including inventory. The Commission also confirmed that the mandate of the Working Group should be interpreted widely to ensure an appropriately flexible work product, which should take the form of a legislative guide.<sup>10</sup>

9. At its second session (Vienna, 17-20 December 2002), the Working Group considered chapters VI, VII and IX (A/CN.9/WG.VI/WP.2 and Add.6, 7 and 9) of the first preliminary draft guide on secured transactions, prepared by the Secretariat. At that session, the Working Group requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/531, para. 15). In conjunction with that session and in accordance with suggestions made at the first session of the Working Group (see A/CN.9/512, para. 65), an informal presentation of the registration systems of security rights in movable property of New Zealand and Norway was held. Immediately before that session, Working Groups V (Insolvency Law) and VI (Security Interests) held their first joint session (Vienna, 16-17 December 2002), during which the revised version of former chapter X (new chapter IX; A/CN.9/WG.VI/WP.6/Add.5) on insolvency was considered. At that session, the

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<sup>8</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, para. 202.

<sup>9</sup> *Ibid.*, para. 203.

<sup>10</sup> *Ibid.*, para. 204.

Secretariat was requested to prepare a revised version of that chapter (see A/CN.9/535, para. 8).

10. At its third session (New York, 3-7 March 2003), the Working Group considered chapters VIII, XI and XII of the first preliminary draft guide on secured transactions and chapters II and III of the second version of the draft Guide (A/CN.9/WG.VI/WP.2/Add.8, A/CN.9/WG.VI/WP.2/Add.11, A/CN.9/WG.VI/WP.2/Add.12, A/CN.9/WG.VI/WP.6/Add.2 and A/CN.9/WG.VI/WP.6/Add.3) and requested the Secretariat to prepare revised versions (A/CN.9/532, para. 13). In conjunction with that session, an informal presentation was made of the recently completed secured transactions law in the Slovak Republic, which was supported by the World Bank and by EBRD.

11. At its thirty-sixth session in 2003, the Commission had before it the reports of Working Group VI (Security Interests) on the work of its second and third sessions (A/CN.9/531 and A/CN.9/532), as well as the report of the first joint session of Working Group V and VI (A/CN.9/535). The Commission commended the Working Group for the progress in its work and expressed its appreciation to Working Group V and Working Group VI for the coordination of their work in relation to the treatment of security rights in insolvency proceedings. The Commission also noted with appreciation the presentation of modern registration systems of security rights in movable property and the plan of the Secretariat to prepare a paper addressing technical registration-related issues.<sup>11</sup>

12. In addition, the Commission emphasized the importance of coordination with organizations with interest and expertise in the field of secured transactions law, such as Unidroit, the Hague Conference on Private International Law, the World Bank, the International Monetary Fund, EBRD and the Asian Development Bank. Reference was made to the current work of Unidroit on security rights in securities, to the World Bank's Principles and Guidelines for Effective Insolvency and Creditor Rights Systems to the extent they concerned secured transactions, to the Model Law on Secured Transactions and the Principles of EBRD, to the Asian Development Bank's Guide to Movables Registries and to the Inter-American Model Law on Secured Transactions of 2002 prepared by the Organization of American States. Reference was also made to the need to coordinate with the Hague Conference with respect to the conflict-of-laws chapter of the draft legislative guide on secured transactions, in particular with respect to the law applicable to the enforcement of security rights in the case of insolvency.<sup>12</sup>

13. With respect to the scope of work, the Commission noted suggestions that the Working Group should consider covering, in addition to goods (including inventory), trade receivables, letters of credit, deposit accounts and intellectual property rights in view of their economic importance as security for credit. As to the substance of the draft legislative guide, the Commission noted statements that, while the draft guide should discuss various workable approaches, it should also include recommendations and, that if alternative recommendations had to be

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<sup>11</sup> Ibid., *Fifty-eighth Session, Supplement No. 17* (A/58/17), para. 217.

<sup>12</sup> Ibid., para. 218.

prepared, their relative merits, in particular for developing countries and for countries with economies in transition, should also be discussed.<sup>13</sup>

14. After discussion, the Commission confirmed the mandate given to Working Group VI at its thirty-fourth session to develop an efficient legal regime for security rights in goods, including inventory, and its decision at its thirty-fifth session that the mandate should be interpreted widely to ensure an appropriate work product, which should take the form of a legislative guide. The Commission also confirmed that it was up to the Working Group to consider the exact scope of its work and, in particular, whether trade receivables, letters of credit, deposit accounts and intellectual and industrial property rights should be covered in the draft legislative guide.<sup>14</sup>

15. At its fourth session (Vienna, 8-12 September 2003), the Working Group considered chapters I (Introduction), II (Key Objectives), IV (Creation), IX (Insolvency) and paragraphs 1 to 41 of chapter VII (Priority), and requested the Secretariat to prepare revised versions of those chapters (see A/CN.9/543, para. 15).

16. Addenda to this introductory document contain chapters I, II and IV of the revised draft guide: chapter I (Introduction), chapter II (Key objectives) and IV (Creation).

17. The remaining chapters are contained in: A/CN.9/WG.VI/WP.9/Add.1 (chapter III: Approaches to security); A/CN.9/WG.VI/WP.9/Add.2 (chapter V: Publicity and filing); A/CN.9/WG.VI/WP.9/Add.3 (chapter VI: Priority); A/CN.9/WG.VI/WP.9/Add.4 (chapter VII: Pre-default rights and obligations); A/CN.9/WG.VI/WP.2/Add.9 (chapter VIII: Default and enforcement); A/CN.9/WG.VI/WP.9/Add.6 (chapter IX: Insolvency); A/CN.9/WG.VI/WP.9/Add.7 (chapter X: Conflict of laws); and A/CN.9/WG.VI/WP.9/Add.8 (Chapter XI: Transition).

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<sup>13</sup> Ibid., paras. 220-221.

<sup>14</sup> Ibid., para. 222.

**Report of the Secretary-General on the draft legislative guide  
on secured transactions, working paper submitted to the Working  
Group on Security Interests at its fifth session**

ADDENDUM

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## Draft legislative guide on secured transactions

*[Prefatory remarks to be prepared at a later stage]*

### I. Introduction

#### A. Purpose

1. The purpose of this Guide is to assist States in the development of modern secured transactions laws with a view to promoting the availability of low-cost secured credit. The Guide is intended to be useful to States that do not currently have efficient and effective secured transactions laws, as well as to States that already have workable laws but wish to review or modernize them, or to harmonize or coordinate their laws with those of other States.

2. The Guide is based on the premise that sound secured transactions laws can have significant economic benefits for States that adopt them, including attracting credit from domestic and foreign lenders and other credit providers, promoting the development and growth of domestic businesses, and generally increasing trade. Such laws also benefit consumers by lowering prices for goods and services and making low-cost consumer credit more readily available. To be effective, such laws must be supported by efficient and effective judicial systems and other enforcement mechanisms. They must also be supported by insolvency laws that respect rights derived from secured transactions laws (see UNCITRAL Legislative Guide on Insolvency Law).

3. The Guide seeks to rise above differences among legal regimes to suggest pragmatic and proven solutions that can be accepted and implemented in States having divergent legal traditions. The focus of the Guide is on developing laws that achieve practical economic benefits for States that adopt them. While it is possible that States will have to incur predictable and limited costs to develop and implement these laws, substantial experience suggests that the resulting short- and long-term benefits to such States should greatly outweigh the costs.

4. All businesses, whether manufacturers, distributors, service providers or retailers, require working capital to operate, to grow and to compete successfully in the marketplace. It is well established, through studies conducted by such organizations as the International Bank for Reconstruction and Development (the World Bank), the International Monetary Fund, the Asian Development Bank and the European Bank for Reconstruction and Development (EBRD), that one of the most effective means of providing working capital to commercial enterprises is through secured credit.

5. The key to the effectiveness of secured credit is that it allows businesses to use the value inherent in their assets as a means of reducing risk for the creditor. Risk is reduced because credit secured by the assets of a debtor gives creditors access to the assets as another source of payment in the event of non-payment by the debtor. As the risk of non-payment is reduced, the availability of credit increases and the cost of credit falls.

6. A legal system that supports secured credit transactions is critical to reducing the perceived risks of credit transactions and promoting the availability of secured

credit. Secured credit is more readily available to businesses in States that have efficient and effective laws that provide for consistent, predictable outcomes for creditors in the event of non-performance by debtors. On the other hand, in States that do not have efficient and effective laws, where creditors perceive the legal risks associated with credit transactions to be high, the cost of credit increases as creditors require increased compensation to evaluate and assume the increased risk. In some States, the absence of an efficient and effective secured transactions regime, or of an insolvency law regime under which security rights are recognized, has resulted in the virtual elimination of credit for small- and medium-size commercial enterprises, as well as for consumers.

7. Creating a legal regime that promotes secured credit not only aids in the cultivation and growth of individual businesses, but also can have a positive effect upon the general economic prosperity of a State. Thus, States that do not have an efficient and effective secured transactions regime may deny themselves a valuable economic benefit.

8. To best promote the availability of low-cost secured credit, the Guide suggests that secured transactions laws should be structured to enable businesses to utilize the value inherent in their property to the maximum extent possible to obtain credit. In this regard, the Guide adopts two of the most essential concepts of successful secured transactions laws, the concepts of priority and publicity. The concept of priority, which allows the ranking of creditors with a security right in the same assets, makes it possible for a business to utilize the value of its assets to the maximum extent possible by granting security rights having a different priority status in the same assets to more than one creditor. The concept of publicity in the form of a system allowing the registration of a notice concerning a secured transaction is designed to promote legal certainty with regard to the relative priority status of creditors and thus to reduce the costs associated with secured transactions.

## **B. Scope**

9. The Guide deals with consensual security rights. However, it contains references to non-consensual rights, such as those provided by statute or judicial process, when the same property is subject to both consensual and non-consensual security rights and the law must provide for the relative priority of such rights (see A/CN.9/WG.VI/WP.9/Add.3, paras. 44-53). The primary focus of the Guide is on core commercial assets, such as commercial goods (inventory and equipment) and trade receivables. However, the Guide proposes that all types of asset are capable of being the object of a security right, including all present and future assets of a business, and covers all assets, with the exception of assets specifically excluded.

10. Examples of excluded assets are ships, aircraft, real property and other assets that are subject to special registration systems. In addition, the Guide does not cover security rights in securities as original encumbered assets because the nature of securities and their importance for the functioning of financial markets raise a broad range of issues that merit special legislative treatment. These issues are dealt with in a text being prepared by the International Institute for the Unification of Private Law (UNIDROIT). The law applicable to security and other rights in securities is not addressed in this Guide since it forms the subject of the Hague Convention on

the Law applicable to Certain Rights in Respect of Securities (The Hague, December 2002). The Guide is structured in such a way that the State enacting legislation based on the regime envisaged in the Guide can, at the same time, implement the texts prepared by UNIDROIT and the Hague Conference, as well as relevant texts prepared by UNCITRAL, such as the United Nations Convention on the Assignment of Receivables in International Trade (New York, December 2001; herein after referred to as “the United Nations Assignment Convention”) and the UNCITRAL Legislative Guide on Insolvency Law. [*Note to the Working Group: In due course, the Working Group may wish to expand on this matter. Also a decision by the Working Group is pending as to whether the Guide will cover assets, such as promissory notes, checks, letters of credit, deposit accounts and intellectual property rights.*]

11. The Guide stresses the need to enable a physical or legal person to create security rights not only in its existing assets but also in its future assets (i.e. assets acquired or created after the execution of the security agreement), without requiring the parties to execute any additional documents or to take any additional action at the time such assets are acquired or created. In addition, the Guide recommends recognition of a security right in all assets of a person through a single security agreement (“all-asset security”, referred to in some legal systems as “enterprise mortgage” or “floating charge”).

12. The Guide also suggests that a broad range of obligations, monetary and non-monetary may be secured, and that both physical and legal persons may be parties to a secured transaction, including consumers, subject to consumer-protection laws. In addition, the Guide is intended to cover a broad range of transactions that serve security functions, including those related to possessory and non-possessory security rights, as well as transactions not denominated as secured transactions (retention of title, transfer of title for security purposes, assignment of receivables for security purposes, financial leases, sale and leaseback transactions and the like). [*Note to the Working Group: The Working Group may wish to consider the inclusion and the treatment of title-based security devices in the Guide. The Working Group may wish to consider in particular whether a modern secured transactions systems should include rules on title-based security devices and, if so, what types of rules on creation, publicity, priority, enforcement, insolvency and cross-border recognition.*]

13. The legal regime envisaged in the Guide is a purely domestic regime. The recommendations of the Guide are addressed to national legislators considering reform of domestic secured transactions laws. However, because secured transactions often involve parties and assets located in different jurisdictions, the Guide also seeks to address the mutual recognition of security rights (and title-based security devices, such as retention of title) validly created in other jurisdictions. This would represent a marked improvement over the laws currently in effect in many States, under which security rights often are lost once an encumbered asset is transported across national borders, and would go far toward encouraging creditors to extend credit in cross-border transactions (see A/CN.9/WG.VI/WP.9/Add.7, paras. 18-22 and 35).

14. Throughout, the Guide seeks to establish a balance among the interests of debtors, creditors (whether secured, privileged or unsecured), affected third persons, purchasers and other transferees, and the State. In so doing, the Guide adopts the premise, supported by substantial empirical evidence, that creditors will accept such



a balanced approach, and will thereby be encouraged to extend low-cost credit, as long as the laws (and supporting legal and governmental infrastructure) are effective to enable the creditors to assess their risks with a high level of predictability and with confidence that they will ultimately realize the economic value of the encumbered assets. Essential to this balance is a close coordination between the secured transactions and insolvency law regimes, including provisions pertaining to the treatment of security rights in the event of a reorganization of a business. Additionally, certain debtors, such as consumer debtors, require additional protections. Thus, although the regime envisioned by the Guide will apply to many forms of consumer transactions, it is not intended to override consumer-protection laws or to discuss consumer-protection policies, since this matter does not lend itself to unification.

15. In the same spirit, the Guide also addresses concerns that have been expressed with respect to secured credit. One such concern is that providing a creditor with a priority claim to all or substantially all of a person's assets may appear to limit the ability of that person to obtain financing from other sources. Another concern is the potential ability of a secured creditor to exercise influence over a business, to the extent that the creditor may seize, or threaten seizure of, the encumbered assets of that business upon default. Yet another concern is that in some cases secured creditors may take most or all of a person's assets in the case of insolvency and leave little for unsecured creditors, some of whom are not in a position to bargain for a security right in those assets. The Guide discusses these concerns and, in those situations where the concerns appear to have merit, suggests solutions.

16. The Guide builds on the work of UNCITRAL and other organizations. Such work includes: the United Nations Assignment Convention; the UNCITRAL Legislative Guide on Insolvency Law; the Convention on International Interests in Mobile Equipment, approved in November 2001; the EBRD Model Law on Secured Transactions, completed in 1994; the EBRD General principles of a modern secured transactions law, completed in 1997; the study on Secured Transactions Law Reform in Asia, prepared by the Asian Development Bank in 2000; the OAS Model Inter-American Law on Secured Transactions, prepared in 2002; and the OHADA Uniform Act Organizing Securities, prepared in 1997 [...].

### **C. Terminology**

17. This Guide adopts terminology to express the concepts that underlie an effective secured transactions regime. The terms used are not drawn from any particular legal system. Even when a particular term appears to be the same as that found in a particular national law, the meaning given to the term may differ. This approach is taken to provide readers with a common vocabulary and conceptual framework and to encourage harmonization of the law governing security rights. The following paragraphs therefore identify the principal terms used and the core meaning given to them in this Guide. The meaning of those terms is further refined when they are used in subsequent chapters. Those chapters also define and use additional terms.

- (a) "Security right" means a consensual property right in movable property and fixtures that secures payment or other performance of one or more obligations.

- (b) “Purchase money security right” means a security right in an asset that secures the credit extended as the purchase price of the asset or other obligation incurred to acquire the asset. Purchase money security rights include, but are not limited to, retention of title and transfer of title for security purposes.
- (c) “Secured obligation” means the obligation secured by a security right.
- (d) “Secured creditor” means a creditor that has a security right.
- (e) “Debtor” means a person that owes performance of the secured obligation. The debtor may or may not be the person that grants the security right to a secured creditor (see grantor).<sup>1</sup>
- (f) “Grantor” means a person that creates a security right in one or more of its assets in favour of a secured creditor. The grantor may or may not be the debtor that owes performance of the secured obligation (see debtor).
- (g) “Security agreement” means an agreement between a grantor and a creditor that creates a right securing one or more of the debtor’s obligations.
- (h) “Encumbered asset” means property subject to a security right. In general, encumbered assets are divided into tangible and intangible property. Each of these two general types of asset comprises several sub-types.
- (i) “Tangibles” means all forms of corporeal movable property. Among the categories of tangibles are inventory, equipment, fixtures, negotiable instruments and negotiable documents.
- (j) “Inventory” means a stock of tangibles (other than tangibles such as negotiable instruments and negotiable documents) held for sale or lease in the ordinary course of business and also raw and semi-processed materials (work-in-process).
- (k) “Equipment” means tangibles (other than tangibles such as negotiable instruments and negotiable documents), other than inventory, used by a person in the operation of its business.
- (l) “Fixtures” means tangibles (other than tangibles such as negotiable instruments and negotiable documents), that can become subject to separate security rights even though they are so closely attached or associated with immovable property as to be treated as immovable property under the law of the State where the immovable property is located.
- (m) “Intangibles” means all movable property other than tangibles. Among the categories of intangibles are claims and receivables.

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<sup>1</sup> For the sake of consistency with the UNCITRAL Legislative Guide on Insolvency Law, the term “debtor” is used in the chapter on Insolvency to mean a person who meets the requirements for the commencement of an insolvency proceeding (see A/CN.9/WG.V/WP.70, Introduction, sect. 2). However, where the security right is granted not by the debtor but by a third party on the basis of some contractual arrangement with the debtor, and both the debtor and the grantor are insolvent, the term “debtor” in the chapter on Insolvency means the grantor, since only in the insolvency of the grantor is the creditor a secured creditor with a proprietary right in the encumbered assets. In the debtor’s insolvency, the creditor is an unsecured creditor with a contractual claim against the debtor.

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- (n) “Claim” means a right to the performance of a non-monetary obligation other than negotiable documents.
  - (o) “Receivable” means a right to the payment of a monetary obligation.
  - (p) “Proceeds” means whatever is received in respect of encumbered assets, including, but not limited to, amounts received upon sale, lease or other disposition, civil and natural fruits, dividends, insurance proceeds and claims arising from damage or loss, and tort or warranty claims.
  - (q) “Priority” means the right of person to derive the economic benefit of its security right in an encumbered asset in preference to other persons having a security or other right in the same asset.
  - (r) “Possessory security right” means a security right in encumbered assets in the possession of a secured creditor or a third party (other than the debtor or the third party grantor) holding the asset for the secured creditor.
  - (s) “Non-possessory security right” means a security right in: (i) tangibles not in the possession of the secured creditor or a third party holding the tangibles for the benefit of the secured creditor, or (ii) intangibles.
  - (t) “Insolvency court” means a judicial or other authority competent to control or supervise an insolvency proceeding.
  - (u) “Insolvency estate” means assets and rights of the debtor that are controlled or supervised by the insolvency representative and subject to the insolvency proceedings.
  - (v) “Insolvency proceedings” means collective judicial or administrative proceedings for the purposes of either reorganization or liquidation of the debtor’s business conducted according to the insolvency law.
  - (w) “Insolvency representative” means a person or body responsible for administering the insolvency estate.
  - (x) “Negotiable instrument” means an instrument that embodies a right to payment, such as a promissory note or a bill of exchange.
  - (y) “Negotiable document” means a document that embodies a right for delivery of tangibles, such as a warehouse receipt or a bill of lading.
  - (z) “Account debtor” means a person liable for payment of a receivable.
  - (aa) “Buyer in the ordinary course of business” means a person who buys goods in the ordinary course from a person in the business of selling goods of that kind and without knowledge that the sale violates the security or other rights of another person in the goods.
  - (bb) “Control” means the legal authority of a secured creditor to direct the disposition of encumbered assets without the need of any further consent or action by the grantor.

## **D. Examples of financing practices to be covered in the Guide**

18. Set forth below are three short examples of the types of secured credit transactions that the Guide is designed to encourage, and to which reference will be made throughout the Guide to illustrate specific points. These examples represent only a few of the numerous forms of secured credit transactions currently in use, and an effective secured transactions regime must be sufficiently flexible to accommodate many existing modes of financing, as well as modes that may evolve in the future.

### **1. Inventory and equipment purchase-money financing**

19. Businesses often desire to finance specific purchases of inventory or equipment. In many cases, the financing is provided by the seller of the goods. In other cases, the financing is provided by a lender instead of the seller. Sometimes the lender is an independent third party, but in other cases the lender may be an affiliate of the seller. The seller or lender is granted by agreement a security right in the goods sold to secure the repayment of the credit or loan. This type of financing is often referred to as purchase-money financing.

20. Here is an example of purchase-money financing: ABC Manufacturing Company (ABC) is a manufacturer of furniture with facilities located in State X and customers located in multiple States. ABC desires to purchase paint from Vendor A and steel tubing from Vendor B, and to lease certain manufacturing equipment from Lessor A, all of which will be used by ABC in manufacturing furniture.

21. Under the purchase agreement with Vendor A, ABC is required to pay the purchase price for the paint within thirty days of delivery to ABC, and ABC grants to Vendor A a security right in the paint until ABC pays the purchase price in full. Under the purchase agreement with Vendor B, ABC is required to pay the purchase price for the steel tubing before it is delivered to ABC. ABC obtains a loan from Lender A to finance the purchase of the steel tubing from Vendor B, secured by a security right in the steel tubing. ABC also maintains a bank account with Lender A and has granted Lender A a security right in the account as an additional security for the repayment of the loan.

22. Under the lease agreement with Lessor A, ABC leases the manufacturing equipment from Lessor A for a period of two years. ABC is required to make monthly lease payments during the lease term. ABC has the option (but not the obligation) to purchase the equipment for a nominal purchase price at the end of the lease term. Lessor A retains title to the equipment during the lease term but title will be transferred to ABC at the end of the lease term if ABC exercises the purchase option. This type of lease is often referred to as a “finance lease”. Under some forms of finance lease, title to the leased property is transferred to the lessee automatically at the end of the lease term. A finance lease is to be distinguished from a lease (often referred to as an “operating lease”) under which the lessee does not have an option to purchase the leased property for a nominal price, title to the leased property is not transferred to the lessee automatically at the end of the lease term, or the leased property has no remaining useful life at the end of the lease.

## 2. Receivable and inventory revolving loan financing

23. Businesses generally have to expend capital before they are able to generate and collect revenues. For example, before a typical manufacturer can generate receivables and collect payments, the manufacturer must expend capital to purchase raw materials, to convert the raw materials into finished goods and to sell the finished goods. Depending on the type of business, this process may take up to several months. Access to working capital is critical to bridge the period between cash expenditures and revenue collections.

24. One highly effective method of providing such working capital is a revolving loan facility. Under this type of facility, loans secured by the borrower's existing and future receivables and inventory are made from time to time at the request of the borrower to fund the borrower's working capital needs (see also A/CN.9/WG.VI/WP.11/Add.2, para. 12). The borrower typically requests loans when it needs to purchase and manufacture inventory, and repays the loans when the inventory is sold and the sales price is collected. Because the revolving loan structure matches borrowings to the borrower's cash conversion cycle (that is, acquiring inventory, selling inventory, creating receivables, receiving payment and acquiring more inventory to begin the cycle again), this structure is, from an economic standpoint, highly efficient and beneficial to the borrower.

25. Here is an example of this type of financing: It typically takes four months for ABC to manufacture, sell and collect the sales price for its products. Lender B agrees to provide a revolving line of credit to ABC to finance this process. Under the line of credit, ABC may obtain loans from time to time in an aggregate amount of up to 80 per cent of the value of its receivables that Lender B deems to be acceptable for borrowing (based upon criteria such as the creditworthiness of the account debtors) and of up to 50 per cent of the value of its inventory that Lender B deems acceptable for borrowing (based upon criteria such as its type and quality). ABC is expected to repay these loans from time to time as it receives payments from its customers. The line of credit is secured by all of ABC's existing and future receivables and inventory.

## 3. Term loan financing

26. Businesses often need financing for large, non-ordinary course expenditures, such as the construction of a new manufacturing plant or the acquisition of a business. In these situations, businesses generally seek financing that is not repayable until long after construction is completed. This type of loan facility is typically referred to as a term loan. In many cases, a term loan is amortized in accordance with an agreed-upon payment schedule.

27. For businesses that do not have strong, well-established credit ratings, term loan financing will generally be available only if the business is able to grant security rights in its assets to secure the financing. The amount of the financing will be based in part on the creditor's estimate of the net realizable value of the assets to be encumbered. In many States, real property is the only type of asset that typically secures term loan financing. However, many businesses, particularly newly-established businesses, do not own any real property and, therefore, may not have access to term loan financing. In other States, term loans secured by other assets, such as equipment and even intellectual property, are common.

28. Here is an example of this type of financing: ABC desires to expand its operations and construct a new manufacturing plant in State Y. ABC obtains a loan from Lender C to finance such construction. The loan is repayable in equal monthly instalments over a period of ten years and is secured by the new manufacturing plant, including all equipment that is either located in the plant at the time the plant begins operating or is thereafter acquired by ABC.

## **II. Key objectives of an effective and efficient secured transactions regime**

29. In the spirit of providing practical, effective solutions, the Guide explores and develops the following key objectives and themes of an effective and efficient secured transactions regime.

### **A. Promote secured credit**

30. The primary overall objective of the Guide is to promote low-cost secured credit for parties in jurisdictions that adopt legislation based on the Guide's recommendations, thereby enabling such parties and the economy as a whole to obtain the economic benefits that flow from access to such credit (see para. 2).

### **B. Allow a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions**

31. A key to a successful legal regime governing secured transactions is to enable a broad array of businesses to utilize the full value inherent in their assets to obtain credit in a broad array of credit transactions. In order to achieve this objective, the Guide emphasizes the importance of comprehensiveness, by: (i) permitting a broad range of assets to serve as encumbered assets (including present and future inventory, equipment and receivables); (ii) permitting a broad range of obligations (including future and conditional obligations) to be secured by security rights in encumbered assets; and (iii) extending the benefits of the regime to a broad array of debtors, creditors and credit transactions.

### **C. Obtain security rights in a simple and efficient manner**

32. The cost of credit will be reduced if security rights can be obtained in an efficient manner. For this reason, the Guide suggests methods for streamlining the procedures for obtaining security rights and otherwise reducing transaction costs. These methods include: eliminating unnecessary formalities; providing for a single method for creating security rights rather than a multiplicity of security devices for different kinds of encumbered assets; and permitting security rights in future assets and for future advances of credit without any additional documentation or actions by the parties.

**D. Recognize party autonomy**

33. Because an effective secured transactions regime should provide maximum flexibility and durability to encompass a broad array of credit transactions, and also accommodate new and evolving forms of credit transactions, the Guide stresses the need to keep mandatory laws to a minimum so that parties may tailor their credit transactions to their specific needs. At the same time, the Guide takes into account that other legislation may protect the legitimate interests of consumers or other persons and specifies that a secured transactions regime should not override such legislation.

**E. Provide for equal treatment of creditors**

34. Because healthy competition among all potential creditors is an effective way of reducing the cost of credit, the Guide recommends that the secured transactions regime apply equally to various creditors, including banks and other financial institutions, as well as domestic and non-domestic creditors.

**F. Validate non-possessory security rights**

35. Because the granting of a security right should not make it difficult or impossible for the debtor or other grantor to continue to operate its business, the Guide recommends that the legal regime provide for non-possessory security rights in a broad range of assets coupled with mechanisms for publicizing the existence of such security rights.

**G. Encourage responsible behaviour by enhancing predictability and transparency**

36. Because an effective secured transactions regime should also encourage responsible behaviour by all parties to a credit transaction, the Guide seeks to promote predictability and transparency to enable the parties to assess all relevant legal issues and to establish appropriate consequences for non-compliance with applicable rules, while at the same time respecting and addressing confidentiality concerns.

**H. Establish clear and predictable priority rules**

37. A security right will have little or no value to a creditor unless the creditor is able to ascertain its priority in the property relative to other creditors (including an insolvency representative). Thus, the Guide proposes the establishment of a system for registering public notices with respect to security rights and, based on that system, clear rules that allow creditors to determine the priority of their security rights at the outset of the transaction in a reliable, timely and cost-efficient manner.

**I. Facilitate enforcement of creditor's rights in a predictable and efficient manner**

38. A security right will also have little or no value to a creditor unless the creditor is able to enforce the security right in a predictable and efficient manner. Thus, the Guide proposes procedures that allow creditors to so enforce their security rights, subject to judicial or other official control, supervision or review when appropriate. The Guide also recommends that there be a close coordination between a State's secured transactions laws and its insolvency laws with a view to respecting the pre-insolvency effectiveness and priority, as well as the economic value, of a security right subject to the appropriate rules of insolvency law.

**J. Balance the interests of the affected persons**

39. Because secured transactions affect the interests of various persons, including the debtor, other grantors, competing creditors, such as secured, privileged and unsecured creditors, purchasers and other transferees, and the State, the Guide proposes rules that take into account their legitimate interests and seek to achieve, in a balanced way, all the objectives mentioned above.

**K. Harmonize secured transactions laws**

40. Adoption of legislation based on the recommendations contained in the Guide will result in harmonization of secured transactions laws (through the adoption of similar substantive laws which will facilitate the cross-border recognition of security rights). This result in itself will promote the financing of international trade and the movement of goods and services across national borders.



**Report of the Secretary-General on the draft legislative guide  
on secured transactions, working paper submitted to the Working  
Group on Security Interests at its fifth session**

ADDENDUM

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## **IV. Creation**

### **A. General remarks**

#### **1. Introduction**

1. This chapter deals with issues relating to the creation of consensual security rights (statutory or judicial rights are mentioned in this Guide only in the context of conflicts of priority; see A/CN.9/WG.VI/WP.9/Add.3, paras. 44-53). Before dealing with the issues relating to the security agreement (see sect. A.3) and other proprietary requirements for the creation of an effective security right (see sect. A.4), this chapter outlines the two basic elements of both, namely the obligations to be secured (see sect. A.2.a) and the assets to be encumbered (see sect. A.2.b)

2. Additional requirements for the effectiveness of a security right against third parties are discussed in chapter VI on priority as they relate to ranking of creditors with a security right in the same asset. Matters related to the effectiveness of a security right in the case of insolvency are discussed in chapter IX on insolvency.

#### **2. Basic elements of a security right**

##### **(a) Obligations to be secured**

###### **i. Connection between security and secured obligation**

3. Security rights are accessory to and dependent upon the obligation they secure. This means that the validity and the terms of the security agreement depend on the validity and the terms of the agreement giving rise to the secured obligation. In particular, with respect to revolving loan transactions, a security right is accessory in the sense that, while it can secure future advances and fluctuating obligations (see para. 12), it cannot be enforced if there is no advance on the loan and cannot surpass the amount of the obligation owed at the time of enforcement.

###### **ii. Limitations**

4. In some countries, non-possessory security rights may relate only to specific types of obligations described in legislation (e.g. loans for the purchase of automobiles or loans to farmers). In other countries with a general regime for possessory security rights only or for both possessory and non-possessory security rights, no such limitations exist. Such a comprehensive approach has the potential of spreading the main benefits derived from secured financing (i.e. greater availability of credit and at a lower cost) to the parties to a wide range of transactions. In addition, such an approach enhances certainty, consistency and equal treatment of all debtors and secured creditors. To the extent such special regimes are necessary for specific socio-economic reasons, adverse effects may be minimized if such regimes are established in a clear and transparent way and are limited to a narrow range of transactions.

**iii. Varieties of obligations****a. Monetary and non-monetary obligations**

5. Both monetary obligations and non-monetary obligations that are convertible to monetary obligations may be secured.

**b. Type of obligation**

6. Unless there is a special regime for security rights in specific types of obligations (e.g. for loans by pawnbrokers), it is not necessary to list in legislation all the types of obligations that can be secured. An exhaustive list would be impossible. However, an indicative list would typically include obligations arising from loans and the purchase of goods, including inventory and equipment, on credit.

**c. Future and conditional obligations**

7. Legal systems differ on the definition of future obligations. In some systems, future obligations are the obligations that have not been contracted for (this is the approach of the United Nations Assignment Convention; see art. 5 (b)). In other systems, even obligations that have been contracted for but are not due at the time of the security agreement (because the loan has not been advanced yet or the loan involves a revolving loan facility; see A/CN.9/WG.VI/WP.11/Add.1, para. 24) are treated as future obligations.

8. The distinction between present and future obligations is significant in those legal systems in which, for reasons of certainty and debtor protection, future obligations may not be capable of being secured or may be secured only up to a maximum amount. As a result, in such jurisdictions, debtors may not be able to benefit from certain transactions, such as revolving loan facilities. In other legal systems, future obligations may be freely secured. In those systems, one security agreement is sufficient to cover both present and future obligations. As a result, each extension or increase of credit does not require that the corresponding security right be modified or even newly created, and this has a positive impact on the availability and the cost of credit. While a security right may be created in a future obligation, it cannot be enforced until the obligation arises and becomes due.

9. Obligations subject to a condition subsequent are treated as present obligations, while obligations subject to a condition precedent are normally treated as future obligations.

**iv. Description****a. Specific description and maximum amount**

10. In some legal systems, it is necessary for the parties to describe the secured obligations in their agreement in specific terms or to set a maximum limit to the amount of the secured obligations. The assumption is that such description or limit is in the interest of the debtor since the debtor would be protected from overindebtedness and would have the option of obtaining additional credit from another party. However, such requirements may result in limiting the amount of credit available and thereby in increasing the cost of credit. In particular, limits as to the amount to be secured imposed by law are unavoidably arbitrary, cannot address

the needs of each individual debtor and would need to be adjusted periodically as they are bound to become outdated.

11. For all those reasons, many legal systems do not require specific descriptions of the secured obligations and allow parties to negotiate freely the amount to be secured, including all sums owed by the debtor to the secured creditor (“all sums clauses”). In those legal systems, the secured obligation must be determined or determinable on the basis of the security agreement whenever a determination is needed (as is the case, for example, when the secured creditor enforces its security rights). All sums clauses are based on the assumption that the secured creditor cannot claim from the encumbered assets more than it is owed and that, if the obligation is fully secured, better credit terms are likely to be offered to the debtor by the secured creditor (see also A/CN.9/WG.VI/WP.9/Add.2, para. 53).

**b. Fluctuating amounts**

12. Modern financing transactions often no longer involve a one-time payment but instead frequently foresee advances being made at different points of time depending on the needs of the debtor (for example, revolving credit facilities for the debtor to buy inventory; see A/CN.9/WG.VI/WP.11/Add.1, para. 24). Such financing may be conducted on the basis of a current account, the balance of which fluctuates daily. If the amount of the secured obligation were to be reduced by each payment made, lenders would be discouraged from making further advances unless they were granted additional security. This would be highly inefficient as it would add to the cost and the time necessary for the debtor to acquire new goods required for the conduct of its business.

**c. Amounts in foreign currency**

13. The amount of the secured obligation may be expressed in any currency. Where there is debtor default (or insolvency) and disposition of the encumbered assets, it may be necessary to convert the proceeds from the disposition of the encumbered assets so that the secured obligation and the encumbered assets are expressed in the same currency. This issue, however, is typically left to the contract from which the secured obligation arises and to the applicable law (e.g. in the absence of an agreement, the exchange rate prevailing at the place of enforcement or insolvency proceedings will prevail).

**(b) Assets to be encumbered**

**i. Object of the security right**

14. The object of the security right may be the debtor’s or other grantor’s ownership or other limited right (e.g. a right of use or lease) in the encumbered assets (including future assets; see paras. 16-18). A principle that is recognized in most legal systems is that the debtor cannot grant to the secured creditor more rights than the debtor has or may acquire in the future. Apart from tangibles (e.g. goods), intangibles (e.g. receivables and other rights) are of growing importance as objects of security rights.

**ii. Limitations**

15. In some legal systems, special laws for specific types of non-possessory security rights introduce limitations as to the types of asset that may serve as security or as to the part of the value of assets that may be encumbered. Such limitations, which are usually intended to protect debtors, prevent debtors from utilizing the full value of their assets to obtain credit. Therefore, the benefits and the negative impact of such limitations need to be carefully weighed. Examples of limitations justified for public policy reasons may include wages and pensions under a certain minimum amount, as well as household goods (unless they secure payment of their own purchase price).

**iii. Future assets**

16. The term “future” covers both assets that already exist at the time of the conclusion of the security agreement but do not belong to the debtor or other grantor (or the debtor or other grantor cannot dispose of them) and assets that, at that point of time, do not even exist.

17. In some countries, future assets may not be used as security. This approach is partly based upon technical notions of property law (e.g. what does not exist cannot be transferred or encumbered). It is also based on the concern that allowing broad dispositions of future assets may inadvertently result in overindebtedness and in making the debtor excessively dependent on one creditor, preventing the debtor from obtaining additional secured credit from other sources (see para. 24). Yet another argument offered for not permitting the creation of security rights in future assets is that the possibility that unsecured creditors of the debtor will obtain satisfaction for their claims may be significantly reduced. However, technical notions of property law should not be invoked to pose obstacles to meeting the practical need of using future assets as security to obtain credit. In addition, business debtors can protect their own interests and do not need statutory limitations on the transferability of rights in future assets. Moreover, permitting future assets to be encumbered makes it possible for debtors with insufficient present assets to obtain credit, which is likely to enhance their business and benefit all creditors, including unsecured creditors.

18. In other countries, the parties may agree to create a security right in a future asset. The disposition is a present one but it becomes effective as to the future asset only when the debtor or other grantor becomes the owner of the asset or the asset comes into existence. The United Nations Assignment Convention takes this approach (see art. 8 (2) and art. 2 (a)). Permitting the use of future assets as security for credit is important, in particular, for securing claims arising under revolving loan transactions (see para. 12) by a revolving pool of assets. Assets to which this technique is typically applied include inventory, which by its nature is to be sold and replaced, and receivables, which after collection are replaced by new receivables. The main advantage of this approach is that one security agreement may cover a changing pool of assets that fit the description in the security agreement. Otherwise, it would be necessary to continually amend security agreements or enter into new ones, a result that could increase transaction costs and decrease the amount of credit available, in particular on the basis of revolving credit facilities.

**iv. Assets not specifically identified**

19. In some legal systems, the encumbered assets need to be specifically identified. While such a requirement is intended to protect the debtor from excessive limitations, it also limits availability of credit since specific identification may not be possible for assets such as inventory and, to some degree, receivables. To address this issue, many countries have developed rules that allow the parties to describe the assets to be encumbered only in general terms. The specific identification, generally required, is transposed from the individual items to an aggregate, which in turn has to be generally identified. In some legal systems, even a description referring to all assets, present and future, is sufficient (e.g. “all my assets, presently owned and hereafter acquired”). In some of those legal systems, such a generic identification of encumbered assets is not allowed with respect to assets of consumers or even individual small traders.

**v. All-asset security**

20. In some legal systems, for the same reasons future assets or assets not specifically identified may not be encumbered (see paras. 16-18), a debtor is not permitted to grant security in all of its assets. In other legal systems, debtors are permitted to grant a security right in all of their assets up to a certain percentage of their total value. Such limitations, which are intended to provide some protection for unsecured creditors, are bound to limit the credit available and increase the cost of credit.

21. To enhance the availability of secured credit, some legal systems permit the creation of a non-possessory security right in all of the assets of a debtor, including tangible and intangible, movable and immovable (although different rules may apply to security in immovables), and present and future assets. The most essential aspects of such all-asset security are that it covers all assets of a debtor and the debtor has the right to dispose of certain of its encumbered assets (such as inventory) in the ordinary course of its business (while the security is extended automatically to the proceeds of the assets disposed). Under most legal systems, such a right to dispose of encumbered assets without affecting the security right is acknowledged. However, in some legal systems, dispositions of encumbered assets by the debtor, although authorized by the creditor, are regarded as irreconcilable with the idea of a security right.

22. Related to, though distinguishable from, the all-asset security is the issue of overcollateralization, which arises in situations where the value of the encumbered assets significantly exceeds the amount of the secured obligation. While the secured creditor cannot claim more than the secured obligation plus interest and expenses (and perhaps damages), overcollateralization may create problems. The debtor's assets may be encumbered to an extent that makes it difficult or even impossible (at least in the absence of a subordination agreement between creditors) for the debtor to obtain a second-ranking security from another creditor. In addition, executions by the debtor's unsecured creditors may be precluded or at least be made more difficult (unless there is excess value). A solution developed by courts in some countries is to declare any security right grossly in excess of the secured obligation plus interest, expenses and damages void or to grant the debtor a claim for release of such excess security. This solution could work in practice, if a commercially adequate margin

may be determined and granted to the secured creditor, which may not be easy in all cases.

23. In some countries, all-asset security takes the form of so called “enterprise mortgages”. An enterprise mortgage may comprise all assets of an enterprise (including, in some countries, even immovables). It may cover, for example, incoming cash, new inventory and equipment, as well as future assets of an enterprise, while present assets that are disposed of in the ordinary course of business are released. The main advantage of an enterprise mortgage is that it allows an enterprise that has more value as a whole to obtain more credit and at a lower cost. An interesting feature of some forms of enterprise mortgage is that upon enforcement by the secured creditor and upon execution by another creditor, an administrator can be appointed for the enterprise. This may assist in avoiding liquidation and in facilitating reorganization of the enterprise with beneficial effects for creditors, the workforce and the economy in general. In practice, however, administrators appointed by the secured creditor may favour the secured creditor. This problem may be mitigated to some extent if the administrator is appointed and supervised by a court or other authority. This feature of an enterprise mortgage may be usefully expanded to all-asset security in the sense that the administrator could be appointed by agreement of the debtor and the secured creditor or by the court and be responsible for enforcement in and outside insolvency. [*Note to the Working Group: The Working Group may wish to consider whether such an administrator should act in the interest of the secured creditor or in the interest of all creditors (see A/CN.9/543, para. 19).*]

24. Enterprise mortgages may present certain disadvantages in practice. One disadvantage is that the secured creditor usually is or becomes the enterprise’s major or even exclusive credit provider and this may affect competition among credit providers and thus negatively affect the availability and the cost of credit to the extent that other creditors are unprotected (although competition is not necessarily precluded since a single major credit provider may offer particularly competitive credit terms). In order to address this problem, some countries introduced limitations on the scope of enterprise mortgages, preserving a percentage of the value of the enterprise for unsecured creditors in the case of insolvency. However, such limitations may have an adverse impact on the availability of credit by effectively reducing the amounts of assets available to serve as security (see A/CN.9/WG.VI/WP.9/Add.6, para. 34). Another possible disadvantage of enterprise mortgages is that, in practice, the holder of the mortgage may fail to sufficiently monitor the enterprise’s business activities and to actively participate in reorganization proceedings since the mortgagee is amply secured. In order to counterbalance the mortgagee’s overly strong position, the debtor-enterprise may be given a claim for the release of grossly excessive security (see para. 22).

25. In other countries, all-asset security takes the form of a so called “floating charge” that is merely a potential security right with a right for the debtor to dispose of certain of the encumbered assets (such as inventory) in the ordinary course of business. Dispositions are barred as of the time the debtor is in default, when the floating charge “crystallizes” to become a fully effective “fixed” charge. Once a legal system permits the creation of non-possessory security rights in all assets of a debtor while the debtor is allowed to dispose of certain of the assets in the ordinary

course of its business, there is no need to preserve the construction or the terminology of enterprise mortgages or floating charges.

**vi. Fixtures, accessions and commingled goods**

26. A movable may be attached to an immovable (and become a fixture) or to another movable in such a way that its identity is not lost (and become an accession) or in a way that its identity is lost (and become commingled). In all these cases, the question arises as to whether a security right, to which the original movable was subject before attachment or commingling, is preserved.

27. In some countries, a security right may be created in movables that are fixtures (without preventing the creation of a security right under real property law) or accessions or may continue in movables that have become fixtures or accessions regardless of the cost or difficulty of removing the fixture or accession from the property to which it was attached and regardless whether the fixture or accession has become an integral part of that property. In those countries, whether the fixture or accession may be identified and readily removed without damage from the property to which it was attached is relevant for determining the priority among competing claimants (see chapter VI on priority). In other countries that do not distinguish between creation and priority, this is an issue of creation.

28. As to commingled goods, in some countries, if encumbered assets become commingled with other assets in a way that the encumbered assets are no longer identifiable, a security right may be converted into a security right in the product or mass (as to priority of competing claims in commingled goods, see chapter VI on priority).

**vii. Liability for damage caused by the encumbered assets**

29. While liability for damage caused by encumbered assets (as a result of breach of contract or tort) is not a secured transactions issue, it is important to be addressed since it may have an impact on the availability and the cost of credit. A particularly important issue is liability for environmental damage caused by assets subject to possessory or non-possessory security rights since the monetary consequences and the prejudice to the reputation of the lender may substantially exceed the value of the encumbered assets. Some laws expressly exempt secured creditors from liability, while other laws limit such liability under certain conditions (e.g. where the secured creditor has no possession or control of the encumbered asset). When no such exemptions from or limitations of liability exist, the risk may be too high for a lender to extend credit. Where insurance is available, it is bound to substantially increase the cost of credit to the debtor.

**(c) Proceeds**

**i. Introduction**

30. When encumbered assets are sold, leased, licensed, exchanged or otherwise disposed of during the time in which the obligation they secure is outstanding, the debtor typically receives, in exchange for those assets, cash, tangible property (e.g. goods or negotiable instruments) or intangible property (e.g. receivables or other rights). Such cash or other tangible or intangible property is referred to in many legal systems as “proceeds” of the encumbered assets. In some cases, the



proceeds of the original encumbered assets may generate other proceeds when the debtor disposes of the original proceeds in return for other property. Such proceeds are sometimes referred to as “proceeds of proceeds”.

31. In other situations, encumbered assets may generate other property for the debtor even without a disposition of these assets. Such property may include, for example, interest or dividends on financial assets, new-born animals and fruits or crops. Property generated in this way by encumbered assets is referred to in some legal systems as “civil fruits” or “natural fruits”.

32. In some legal systems, civil or natural fruits are clearly distinguished from proceeds arising from disposition of encumbered assets and are made subject to different rules. The difficulty in identifying proceeds of disposition and the need to protect rights of third parties in proceeds is often cited to justify this approach. Other legal systems do not distinguish between civil or natural fruits and proceeds of disposition and subject both to the same rules. The difficulty in distinguishing between civil or natural fruits and proceeds, the fact that both civil or natural fruits and proceeds flow from, take the place of or may affect the value of the encumbered assets are among the reasons mentioned to justify this approach.

33. A legal system governing security rights must address two distinct questions with respect to proceeds of disposition and civil or natural fruits (hereinafter referred to collectively as “proceeds”, unless otherwise indicated). The first issue is whether the secured creditor retains the security right if the encumbered asset is transferred from the debtor to another person in the transaction that generates the proceeds (for a discussion of this issue, see A/CN.9/WG.VI/WP.9/Add.3, para. 67).

34. The second issue concerns the secured creditor’s rights with respect to the proceeds. A legal system governing security rights should provide clear answers to certain key questions pertaining to the secured creditor’s rights in proceeds (see paras. 35-41).

## **ii. Existence of security rights in proceeds**

35. The justification for a right in proceeds lies in the fact that, if the secured creditor does not obtain such a right, its rights in the encumbered assets could be defeated or reduced by a disposition of those assets and its expectation to receive any income generated by the assets would be frustrated. If the legal system did not permit the creation of a security right in proceeds upon disposition of encumbered assets, it would not adequately protect the secured creditor against default and thus the value of encumbered assets as a source of credit would diminish. This result, which would have a negative impact on the availability and the cost of credit, would be the same even if the security right in the original encumbered assets were to survive their disposition to a third party. The reason for this result lies in the possibility that a transfer of the encumbered assets may increase the difficulty in locating the assets and obtaining possession thereof, increase the cost of enforcement and reduce the value of the assets.

## **iii. Circumstances in which rights in proceeds may arise**

36. A right in proceeds typically arises where the encumbered assets are disposed of because the proceeds replace the original encumbered assets as assets of the debtor. In systems that treat civil or natural fruits as proceeds, a right in such

proceeds may arise even if no transaction takes place with respect to the encumbered assets (e.g. dividends arising from stocks) because this is consistent with the expectations of the parties.

**iv. Personal or proprietary nature of rights in proceeds**

37. If the secured creditor's right in proceeds is a proprietary right, the secured creditor will not suffer a loss by reason of a transaction or other event, since a proprietary right produces effects against third parties. On the other hand, granting the secured creditor a proprietary right in proceeds might result in frustrating legitimate expectations of parties who obtained security rights in those proceeds as original encumbered assets. However, in legal systems in which creation is distinguished from priority this result would occur only if the creditor with a proprietary right in proceeds had priority over the creditors with a right in proceeds as original encumbered assets and such priority is determined on the basis of time of filing of a notice about the transaction in a public register. Thus, in those systems, potential financiers are forewarned about the potential existence of a security right in assets of their potential borrower (including proceeds of such assets) and can take the necessary steps to identify and trace proceeds, and to obtain inter-creditor subordination agreements where appropriate.

**v. Identification of proceeds**

38. When property constituting proceeds of encumbered assets is not kept separately from other assets of the debtor, the question arises as to whether the security right in the proceeds is preserved. The answer to this question usually depends on whether the property constituting proceeds is identifiable. Proceeds in the form of goods kept with other assets of the debtor can be identified as proceeds in any manner that is sufficient to establish that the goods are proceeds. When goods that are proceeds are so mixed with other goods that their separate identity is lost in a product or mass (for example, through manufacturing or production as in the flour that becomes part of baked goods), a security right in the product or mass may be provided by the legal system as a substitute for the security right in the proceeds.

39. If the property constituting proceeds is intangible (rather than goods), such as receivables or balances in deposit accounts, and is not maintained separately from the debtor's other assets of the same type, such intangible property may be identified as proceeds if they can be traced to the original encumbered assets on the basis of tracing rules. Examples of tracing rules include: (i) "first-in, first-out" ("FIFO"), which assumes that the first property to become part of a commingled mass is the first property withdrawn from the mass; (ii) "last-in, first-out" ("LIFO"), which assumes that the last property to become part of a commingled mass is the first property withdrawn from the mass; and (iii) the "lowest intermediate balance rule" ("LIBR"), which assumes, to the extent possible, that withdrawals from the commingled mass are not proceeds of the encumbered assets (for priority in proceeds, see A/CN.9/WG.VI/WP.9/Add.3, paras. 65-73).

**vi. Basis of the rights in proceeds**

40. In some legal systems, the law extends security rights in encumbered assets to proceeds and to proceeds of proceeds through default rules applicable in the absence of an agreement to the contrary. In other legal systems, such a statutory right in

proceeds does not exist, but parties may take security rights in all types of asset. In such systems, parties may be free to provide, for example, that a security right is created in substantially all of the debtor's assets (cash, inventory, receivables, negotiable instruments, securities and intellectual property rights). In such a way, the proceeds themselves become original encumbered assets and are covered by the security right of the creditor even without a legal rule automatically providing a right in proceeds. In some of those legal systems, parties may extend by agreement certain title-based security rights (e.g. retention of title) to proceeds (see A/CN.9/WG.VI/WP.9/Add.1, para. 36; see also para. 61 below).

**vii. Proceeds of proceeds**

41. If there is a right in proceeds of encumbered assets, it should extend to proceeds of proceeds. If the secured creditor loses its right in the proceeds once they take another form, the secured creditor would be subject to the same credit risks as would be the case if there were no rights in proceeds (see para. 35).

**3. Security agreement**

**(a) Functions**

42. The security agreement may fulfil several functions, including that it may: (i) provide the legal basis for granting a security right; (ii) establish the connection between the security right and the secured obligation; (iii) generally regulate the relationship between the debtor or other grantor and the secured creditor (for pre-default rights, see A/CN.9/WG.VI/WP.9/Add.4; for post-default rights, see A/CN.9/WG.VI/WP.9/Add.5 and A/CN.9/WG.VI/WP.9/Add.6); and (iv) minimize the risk of disputes as to its contents and of manipulation after default. While the security agreement may be a separate agreement, often it is contained in the underlying financing contract or other similar contract (e.g. contract of sale of goods on credit) between the debtor and the creditor.

**(b) Parties**

43. In most cases, the security agreement is concluded between the debtor as grantor of the security right and the creditor as the secured party. Occasionally, if a third person grants the security for the benefit of the debtor, this person becomes a party to the agreement instead of or in addition to the debtor. In the case of large loans granted collectively by several lenders (especially in case of syndicated loans), a third party, acting as agent or trustee for the lenders, may hold security rights on behalf of all of the lenders. Security agreements may be tailored to cover each of these situations. While some systems introduce limitations (e.g. only enterprises may grant an enterprise mortgage), in other systems both natural and legal persons may be parties to a security agreement.

**(c) Minimum contents**

44. Legal systems differ as to the requirements for an effective security agreement. However, the security agreement typically has to identify the parties and reasonably describe the obligation to be secured and the assets to be encumbered. Whether or not legislation lists these matters as the minimum contents of a security agreement, failure to deal with them in the security agreement may result in disputes

concerning the scope of the assets encumbered and the obligation secured, unless the missing elements may be established through other means.

45. The parties may clarify in the security agreement additional matters, such as the duty of care on the part of the party in possession of the encumbered assets and representations with respect to the encumbered assets. In the absence of an agreement, default rules may apply to clarify the relationship between the parties (for pre-default issues, see A/CN.9/WG.VI/WP.9/Add.4; for post-default issues, see A/CN.9/WG.VI/WP.2/Add.9 and A/CN.9/WG.VI/WP.9/Add.6).

**(d) Formalities**

46. Legal systems differ as to form requirements for security agreements and their function. In particular, some legal systems do not require that there be a written security agreement, while other legal systems require a simple writing, a signed writing, a notarized writing or an equivalent court or other document (as is the case with enterprise mortgages). Normally, written form performs the function of a warning to the parties of the legal consequences of their agreement, of evidence of the agreement and, in the case of authenticated documents, of protection for third parties against fraudulent antedating of the security agreement. Written form may also be a condition of effectiveness between the parties or as against third parties or of priority among competing claimants. It may also be a condition for obtaining possession of the encumbered assets or for invoking the security agreement in the case of enforcement, execution or insolvency.

47. In some legal systems, a certification of the date by a public authority is required for possessory security rights, with the exception of small-amount loans where proof even by way of witnesses is permitted. While such certification may address the problem of fraudulent antedating, it may raise a problem with respect to the time and cost required for a transaction. In other legal systems, a certified date or authentication of the security agreement is required for various types of non-possessory security (see, for example, articles 65, 70, 94 and 101 of the OHADA Act). In some of those systems, such certification is required instead of publicity by registration. Where, however, registration is necessary, an additional certification of the date of the security agreement is not required.

48. In the interest of saving time and cost, mandatory form requirements need to be kept to a minimum. A simple writing (including, for example, general terms and conditions or a bill) may be sufficient as long as it clearly indicates the intention of the grantor to grant a security right. It could be in the form of an electronic data message (i.e. "information generated, sent, received or stored by electronic, optical or similar means, including, but not limited to, electronic data interchange (EDI), electronic mail, telegram, telex or telecopy" see art. 2 (a) of the UNCITRAL Model Law on Electronic Commerce), which includes a record created and stored but not communicated (see para. 30 of the Guide to Enactment of the Model Law). Alternatively, the matter may be left to the general law of obligations and to the parties to the security agreement.

49. For security in all assets of a debtor or cases where the security agreement can serve as sufficient title for execution (see para. 46), a more formal document may be necessary. Alternatively, in such a case, no writing may be required but the secured

creditor will have to bear the burden of establishing the contents and the date of the security agreement.

**(e) Effects**

50. In some countries, in which property rights are only those that can be asserted against all persons, a fully effective security right only comes into being upon conclusion of the security agreement and completion of an additional act (delivery of possession, notification, registration or control; see para. 57).

51. In other countries, a distinction is drawn between effects as between the parties to the security agreement and effects as against third parties. In those countries, the security comes into existence upon conclusion of the security agreement but only between the contracting parties. An additional act is required for the security to take effect against third parties and serves as a basis for determining priority. The main advantage of this approach is that, by introducing the notion of priority, it makes it possible for debtors to offer the same assets as security to more than one creditor (up to the full value of the assets) and makes possible the ranking of several creditors (see A/CN.9/WG.VI/WP.11/Add.1, para. 8 and A/CN.9/WG.VI/WP.9/Add.2, paras. 7-14).

**4. Proprietary requirements**

**(a) Ownership, limited property right, right of disposition**

52. In most legal systems, the grantor of the security (who normally is the debtor but may also be a third party) has to be the owner of the assets to be encumbered or have some limited proprietary right in the assets (see para. 14). In other legal systems, it is sufficient if the grantor has the power to dispose of the assets (but no ownership). With respect to future assets, it suffices if the grantor becomes the owner or obtains the power of disposition at a future time (see paras. 16-18).

53. Where the grantor does not have the ownership or the power to dispose of the assets, the question arises whether the secured creditor can nevertheless acquire the security right in good faith. In some legal systems, the creditor acquires the security right if its belief that the grantor has ownership, a limited property right or the power to dispose of the assets is supported by objective criteria (e.g. the grantor is registered as the owner of the assets to be encumbered or holds them and transfers possession thereof to the creditor). In other countries an additional element is that the creditor has or is about to extend credit to the debtor.

**(b) Contractual restrictions of right of disposition**

54. In some countries, effect is given to contractual restrictions on dispositions in order to protect the interest of the party in whose favour the restriction is agreed upon. In other countries, no effect or only a limited effect is given to contractual restrictions of dispositions so as to preserve the grantor's freedom of disposition, in particular if the person acquiring a right in an asset is not aware of the contractual restriction.

55. The United Nations Assignment Convention takes a similar approach to support transferability of receivables, which is in the interest of the economy as a whole. Under article 9, paragraph 1, of the Convention, an assignment is effective

despite a contractual restriction on assignment agreed upon between the assignor (“debtor” in the terminology of the Guide) and the debtor (“account debtor” in the terminology of the Guide). However, the effect of this provision is limited in two ways. Firstly, its application is limited to trade receivables broadly defined (see art. 9, para. 3); and secondly, if such a contractual restriction is valid under law applicable outside the Convention, article 9 does not invalidate it as between the assignor and the debtor (see art. 9, para. 2). The debtor is free to claim damages from the assignor for breach of contract, if such a claim exists under law applicable outside the Convention but may not raise this claim against the assignee by way of set-off (see art. 18, para. 3). In addition, mere knowledge of the existence of the restriction on the part of the assignee (“secured creditor” in the terminology of the Guide) is not enough for the avoidance of the contract from which the assigned receivable arises (see art. 9, para. 2).

56. This approach promotes receivables financing transactions since it relieves the assignee (i.e. the secured creditor) of the burden of having to examine the contracts from which the assigned receivables arose, in order to ascertain whether transfer of the receivables has been prohibited or made subject to conditions. Otherwise, lenders would have to examine a potentially large number of contracts, which may be costly or even impossible (e.g. in the case of future receivables).

**(c) Transfer of possession, control, notification, registration**

57. In some countries, in addition to the security agreement some other act is required for a security right to be created (transfer of possession, control, notification and registration). In other countries, the security agreement is sufficient to create the security right as between the grantor and the secured creditor, while an additional act is required for the effectiveness of the security right as against third parties. What that act might be varies from country to country, and even within individual countries, according to the type of security right involved (see A/CN.9/WG.VI/WP.9/Add. 2 and 3).

**5. Title-based security devices**

58. Certain agreements relating to title may serve security purposes. Such devices include retention of title, transfer of title for security purposes, assignment for security purposes, as well as sale and resale, sale and leaseback, hire-purchase and financial leasing transactions.

59. In legal systems with comprehensive secured transactions laws, title-based devices that serve security purposes are generally created in the same way as any other security right (they are either replaced by a uniform notion of security right or while their various terms are preserved their creation and effects are made subject to the rules applicable to security rights). In some of these legal systems, in view of the importance of suppliers of goods and materials for the economy, a policy decision is made to grant them a special priority status (see A/CN.9/WG.VI/WP.9/Add.2, para. 22). Any person financing the acquisition of goods may be granted such a right, whether it is a supplier or a financing institution. This approach is based on the need to promote competition between suppliers of goods on credit and financing institutions in view of the beneficial impact of such competition on the availability and the cost of credit (see A/CN.9/WG.VI/WP.9/Add. 3, para. 29).

60. In other legal systems, title-based devices are in essence the only or the main non-possessory security rights and are subject to various statutory and case law rules. Such legal systems differ widely in several respects. In some systems, only retention of title is subject to a specific regime, while transfer of title in goods and the assignment of receivables for security purposes are subject to the same rules governing the creation of security rights.

**(a) Retention of title**

61. Legal systems that treat title-based devices as non-security devices differ widely with respect to the requirements for the creation and the economic importance they attach to retention of title. In some systems, retention of title is used widely and is effective as against all parties, while in other systems it is insignificant and is generally ineffective or at least as against the administrator in the buyer's insolvency. One point on which many legal systems converge is that mainly simple retention of title is treated as a genuine title device, while all sums clauses, proceeds and products retention of title clauses are treated as true security devices (for the various types of retention of title clauses, see A/CN.9/WG.VI/WP.9/Add.1, paras. 36 and 37). Another point on which many legal systems that treat retention of title as a genuine title device converge is that only the seller may retain title, while another lender may obtain the retention of title only if it receives an assignment of the outstanding balance of the purchase price. Countries that follow this approach wish to protect suppliers of goods on credit over institutions financing the acquisition of goods in view of the importance of suppliers of goods (manufacturers and distributors) for the economy and the dominant position of financing institutions in credit markets.

62. In some legal systems, retention of title derives from a clause in the sales agreement, which may be concluded even orally or by reference to printed general terms. In other systems a writing, a certain date or even registration may be required. In some systems, if goods subject to retention of title are commingled with other goods, the retention of title is extinguished, while in a few other systems the retention of title is preserved as long as the same or equivalent goods are found in the hands of the buyer. In some systems, retention of title is preserved even if the goods are processed in a new product or the proceeds are commingled with other assets, while in other systems retention of title cannot be extended to new products or commingled proceeds. In some systems, a new buyer can acquire ownership of the goods if the initial buyer has the right to resell the goods, while in other systems the new buyer may acquire ownership even if the initial buyer does not have the right to resell the goods but only if the new buyer has no actual knowledge of the retention of title by the initial seller. In a few systems, courts have recognized that the buyer acquires an expectancy of ownership, which is treated as equivalent to ownership. Thus, the buyer has the right to resell the goods or to grant a security right in the goods (the buyer's expectancy of ownership is part of the buyers estate in the case of insolvency).

**(b) Transfer of title and assignment of receivables for security purposes**

63. Legal systems differ on the terminology used and the requirements for the creation and effects of fiduciary transfers of title for security purposes. In some legal systems, a security transfer of title is void as against third parties or even as

between the transferor and the transferee. In other legal systems, while a security transfer of title is effective, it is not widely used in view of the existence of other non-possessory security rights. In most of the legal systems that recognize the security transfer of title, its creation and effects, or at least its major effects, are subject to the same rules applicable to secured transactions in general or at least in the case of the transferor's insolvency. In some of these systems, registration is necessary for a security transfer of title to be effective in general or at least as against third parties.

64. With respect to the assignment of receivables, which is in wide use, a trend is developing in subjecting it to the same provisions whether it involves an outright transfer, an outright transfer for security purposes or a security transfer. This trend is reflected in the United Nations Assignment Convention (see art. 2). However, legal systems differ as to the requirements for an effective assignment. Some legal systems require a writing or notification of the account debtor. Other legal systems require a writing for effectiveness as between the assignor and the assignee and registration for effectiveness as against third parties. Legal systems also differ with respect to the effectiveness of assignments of future receivables and receivables not specifically identified, as well as with respect to the effectiveness of assignments made despite anti-assignment clauses in the contracts from which the assigned receivables arise. The United Nations Assignment Convention validates all those assignments (see arts. 8-10).

**(c) Contractual arrangements with a security function**

65. Sale and resale, sale and lease-back, hire-purchase and financial leasing transactions often perform security functions. In some legal systems, they are treated as security devices, while in other legal systems they are treated as contractual arrangements creating personal rights. In those legal systems that treat them as non-security devices, the requirements for their creation and effects differ widely.

**B. Summary and recommendations**

66. It should be possible to secure all types of obligations, including future obligations and a fluctuating amount of obligations. It should also be possible to provide security in all types of asset, including fixtures, and accessions, as well as in assets which the debtor may not own or have the power to dispose of, or which do not exist, at the time of creation of the security right and proceeds of encumbered assets. Any exceptions to these rules should be limited and described clearly in secured transactions legislation.

67. A security agreement creating a non-possessory security right should be in written form. The writing should include a data message and clearly indicate the grantor's intention to grant a security right. It should identify the parties and reasonably describe the secured obligation and the encumbered assets (but should not require a specific description of each encumbered asset). No writing should be required for possessory security rights. Where no formalities are required, the secured creditor should have the burden of proving both the terms of the security agreement and the date of creation of the security.



68. An agreement between the secured creditor and the grantor and transfer of possession of the encumbered asset to the secured creditor or to an agreed third party is necessary for the creation of a possessory security right.

69. An agreement should be sufficient for the creation of a non-possessory security right as between the grantor and the secured creditor. An additional act may be required for the security right to become effective as against third parties.

*[Note to the Working Group: The Working Group may wish to consider recommendations with regard to title-based security.]*



## VI. POSSIBLE FUTURE WORK

### Possible future work in the area of public procurement (Provisional agenda item (9))

(A/CN.9/553) [Original: English]

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## I. Introduction

1. In 1981, the United Nations Commission on International Trade Law (UNCITRAL), at its fourteenth session, decided that further to strengthen the coordinating role of the Commission, the Secretariat should select, at appropriate intervals, a particular area for consideration and should submit a report focusing, inter alia, on the work already undertaken in that area, indicating topics suitable for legal unification and modernization.<sup>1</sup>
2. The Secretariat selected the law of procurement of goods, construction and services for such a discussion by the Commission. Accordingly, the Secretariat presented two notes on the question of public procurement to the Commission at its thirty-sixth session, held in Vienna from 30 June-11 July 2003 (A/CN.9/539 and A/CN.9/539/Add.1). Those notes set out current activities of other organizations in the area of public procurement and presented information on practical experience in the implementation. The notes were conceived as a starting point in the formulation of proposals as to how to address the issues raised, with a view to their consideration by a working group that may be convened in the third quarter of 2004, subject to confirmation by the Commission at its thirty-seventh session.
3. In its report on the thirty-sixth session, the Commission expressed strong support for the inclusion of procurement law in the work programme of the Commission, inter alia, so as to allow novel issues and practices that have arisen since the adoption in 1994 of the UNCITRAL Model Law to be considered.<sup>2</sup>
4. In this regard, the Commission requested the Secretariat to prepare detailed studies on issues regarding public procurement as identified in the notes presented to it.<sup>3</sup>
5. The Commission also noted that its work might also extend to the formulation of best practices, model contractual clauses and other forms of practical advice, in addition or as an alternative to legislative guidance. It was further noted that the Secretariat's studies and proposals should take into account the fact that, in some countries, public procurement was not a matter for legislation, but for internal directives of ministries and government agencies.<sup>4</sup>
6. The Secretariat's work undertaken thereafter has been carried out in close cooperation with organizations having experience and expertise in the area, such as the World Bank, and has received the benefit of consultations with experts in the field. The Secretariat's studies on issues regarding public procurement, as requested by the Commission, have also taken into account negotiations held under the auspices of the World Trade Organization and other international and regional organizations.
7. This note by the Secretariat sets out a summary of those studies undertaken, and is presented as a follow-up to notes A/CN.9/539 and A/CN.9/539/Add.1, and in

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<sup>1</sup> *Official Records of the General Assembly, Fourteenth Session, Supplement No. 17 (A/36/17)*, para. 100.

<sup>2</sup> *Ibid.*, *Thirty-sixth session, Supplement No. 17 (A/58/17)*, para. 229.

<sup>3</sup> *Ibid.*, para. 230.

<sup>4</sup> *Ibid.*

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order to assist the Commission in considering how to address the issues raised in this field.

## **II. History and purpose of UNCITRAL Model Law on Procurement of Goods, Construction and Services**

8. As set out in the Secretariat's note A/CN.9/539, paragraph 2 "[t]he UNCITRAL Model Law, and an accompanying Guide to Enactment,<sup>5</sup> is intended to serve as a model for States for the evaluation and modernization of their procurement laws and practices and the establishment of procurement legislation where none previously existed. Further, the UNCITRAL Model Law contains procedures aimed at achieving competition, transparency, fairness, economy and efficiency in the procurement process and has proved to be an important international benchmark in procurement law reform. Legislation based on or largely inspired by the UNCITRAL Model Law has been adopted in more than 30 jurisdictions in different parts of the world and the use of that law has resulted in widespread harmonization of procurement rules and procedures."

9. However, as previously reported to the Commission, experience of law reform based on the UNCITRAL Model Law, together with new issues and practices that have arisen in its practical application, may justify an effort to review certain of the issues addressed in its text. Specifically, the increased use of electronic commerce for public procurement, including methods based on the Internet, are capable of further promoting the objectives of procurement legislation. Further, the activities of selected international and regional organizations in the area of government procurement reflect the growing importance of procurement regimes for the development of national economies and for regional and interregional integration. They also highlight the need for harmonized and modern models and for coordination of efforts by international bodies active in the field of procurement.

## **III. Procurement applications of electronic communications and technologies**

10. There are two main technological developments in the last ten years that have changed the manner in which procurement has been undertaken: first, the use of electronic means of communication has become widespread and, secondly, certain States now operate some parts of their procurement electronically (that is, tenders or other means of awarding contracts are conducted online, using a proprietary system or over the Internet). Procurement conducted through electronic means is rapidly increasing in popularity and is being considered both under domestic laws and by the World Trade Organization (WTO) and the European Union.

11. However, although recent documents of international lending institutions addressing standards for assessing national procurement systems encourage the use of electronic means, they do not provide principles that would guide its regulation. Specific comments and suggestions have been brought to the attention of the

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<sup>5</sup> The Guide to Enactment of the UNCITRAL Model Law on Procurement of Goods, Construction and Services (A/CN.9/403).

Secretariat that address ways of adapting the UNCITRAL Model Law to electronic procurement. Accordingly, the Commission may consider that, in addition to dealing with a number of basic issues of electronic procurement, guidance could usefully be provided on methods of electronic procurement.

12. The Secretariat considers the issues raised from the perspective of how they may be addressed in the UNCTRAL Model Law within its existing provisions or, if further provision may be necessary, from the perspective of its aims and existing provisions. Many electronic procurement practices can be accommodated through the interpretation of existing laws and rules, but some undesirable obstacles to the use of electronic commerce in procurement may still remain.<sup>6</sup>

13. Electronic means of communication are used by procuring entities for communicating with suppliers, and with the public and other public bodies, and in a government's internal administrative processes. They can be employed at all stages of the procurement cycle: that is, in planning, in the procurement process itself through advertising and the transmission of documents and information—such as specifications and invitations to tender, and in tendering itself. They are also used in administering the ultimate contract, from the placement of orders, through invoicing to payment.

14. The potential advantages of the use of electronic commerce include improved value for money arising from downwards pressure on prices, as a greater number of potential suppliers can be reached, and in some cases through the promotion of standardization. They also include improved efficiency of operation, from savings on transaction costs (such as the costs of paper processing), savings from speedier communications and easier access to supplier and contract information, and improved compliance with rules and policies, including the ability to improve monitoring.

15. The extent to which individual States can benefit from electronic procurement will depend on various factors, including access to and use of reliable and affordable electricity, telecommunications, and adequate hardware and software, the adequacy of the general law on electronic commerce, the extent of standardization, and available human resources. Recalling that public procurement is not always a matter for legislation, but for internal directives of ministries and government agencies, the Commission may wish to consider whether there is a need for more detailed provisions in enacting States' own national legislation so as to offer the appropriate level of regulation, and whether relevant principles should be explained in the Guide to Enactment that accompanies the UNCITRAL Model Law.

16. The secretariat addresses certain of the issues raised by the increasing use of electronic communications in the procurement process in the following sections of this note.

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<sup>6</sup> Some such obstacles relate to electronic procurement procedures and might not be fully addressed by uniform legislation, in particular the UNCITRAL Model Law on Electronic Commerce (1996) and the UNCITRAL Model Law on Electronic Signatures (2001) (A/56/17 and Corr.3, annex II; see also General Assembly resolution 56/80, annex), which are based on the principle of functional equivalence of electronic and paper-based messages.

## **A. Publication of contract opportunities**

17. The aims of the UNCITRAL Model Law will best be achieved if opportunities are publicized as widely as possible at reasonable cost, and therefore the issue arises as to whether those aims would be furthered by requiring electronic publication of opportunities in addition to, or as an alternative to, more traditional means.

18. It has been suggested to the Secretariat that electronic publications are at their most effective when they are mandatory (that is, when paper publications are not permitted in addition). However, there may be significant advantages even when electronic means are optional. Further, any enhanced benefits from mandatory electronic means could be outweighed by increased costs, especially in the early stages of implementing electronic systems. The Commission may therefore wish to consider whether (given the current circumstances in various States) legislative rules addressing the issue of mandatory or optional use of electronic publication may be needed (and the related question of whether provision of such rules is appropriate, if they might restrict the accessibility of the information concerned).

19. Article 24 of the UNCITRAL Model Law requires that participation in a procurement must be advertised by publication in a place specified by the enacting State when implementing the UNCITRAL Model Law and (for international procurements) a “newspaper” or “relevant trade publication or technical or professional journal” of wide international circulation. This provision implies a paper means of publication. Other procurement regimes have differing publication requirements: one regional body, for example, issues information regarding opportunities in electronic form only, but other bodies allow for any medium that satisfies requirements as to accessibility.

20. Electronic publication might alternatively be required where it is possible in the State concerned, even if as a supplement to paper means, if it is viewed as providing wider publication at limited cost. Similarly, a greater amount of information could be provided electronically, as the costs of so doing are expected to be lower than by the use of traditional paper means. The Commission may wish to address whether the provision of legislative guidance would be required, either in the UNCITRAL Model Law or its accompanying Guide to Enactment, covering, *inter alia*, such issues as flexibility, who should decide on a publication medium, whether the use of electronic means only should be justified, upon what grounds such decisions may be taken, and who should bear the responsibility of an omission.

## **B. Publication of the laws and regulations governing procurement contracts**

21. Article 5 of the UNCITRAL Model Law requires regulations, administrative rulings and directives of general application to be “promptly made accessible to the public and systematically maintained”. This article is sufficiently broad in scope as to encompass publication in any manner—electronic or otherwise, but an express provision permitting or requiring electronic publication may be viewed as desirable. Further, the Commission may wish to address whether there is a need for a legislative rule in this area, considering the limited cost of electronic publication of information, and whether information relevant to potential suppliers (such as internal policies or guidance) that is not currently required to be published should be published by electronic or any available means. The issues set out in the previous

paragraph will also apply to the question of publication of relevant laws and regulations.

### **C. Publication of solicitation documents and related information**

22. Article 27 of the UNCITRAL Model Law addresses the information to be included in solicitation documents. There is no specific reference to information on use of electronic means, but article 27 (z) enables the procuring entity to include any other requirements that it has established relating to the procurement proceedings and such information on the use of electronic means of communication and tendering could be included. The Guide to Enactment suggests that States may wish to make further regulations on such matters.

### **D. Publication of contract awards**

23. Article 14 of the Model Law requires procuring entities to publish notices of contract awards above a threshold specified by the enacting State, and that regulations may provide for the manner of publication. Again, this article is sufficiently broad in scope as to encompass publication in any manner—electronic or otherwise, but an express provision permitting or requiring electronic publication may be viewed as desirable, taking into account the issues raised in paragraph 20 above.

### **E. Use of electronic communications in the procurement process**

24. Electronic communications can be used throughout the procurement procedure, for the distribution of tender documents and invitations to participate, the submission of pre-qualification information, tenders and proposals, among others. The advantages include reduced processing costs, speedier communications, a potential for reduced corruption and abuse (as a result of less direct contact between officials and suppliers, and greater anonymity of tenders) and more reliable communication for non-local suppliers, in States in which postal delivery is unreliable. These advantages can result in increased competition, such as if they lead to wider participation by non-local firms.

25. Article 9 (1) of the UNCITRAL Model Law requires communications to be in a form that provides a record (or, as an alternative for most communications, to be confirmed in a form that provides a record), and so does not exclude electronic means of communication.

26. The possibility of the submission of electronic tenders is also not excluded under the UNCITRAL Model Law, in the sense that article 30, paragraph 5 (b), specifically provides that “a tender may [...] be submitted in any [...] form specified in the solicitation documents that provides a record of the content of the tender and at least a similar degree of authenticity, security and confidentiality”. Apart from the rules on the requirement for a record in article 9 (1) as set out above, the UNCITRAL Model Law does not provide any explicit controls over use of electronic means, except when such means are used for submitting tenders in formal tendering. For example, there is no requirement to ensure that confidentiality of



information in documents submitted by suppliers can be maintained at an equivalent level to that possible for paper documents. Accordingly, it may be useful, and perhaps necessary, that a provision such as article 30 be accompanied by some detailed provisions dealing with authenticity, security and confidentiality, such that suppliers and the public have the same degree of confidence in electronic procedures as in paper-based procedure and so as to ensure, for example, that tenders remain confidential during the tendering procedure.

27. Other related issues for consideration include the communications means and mechanisms used that would ensure that the integrity of data is preserved, will enable entities to establish the time of receipt of documents, when the time of receipt is significant in applying the rules of the procurement process, and will ensure that tenders and other significant documents are not accessed by the procuring entity or other persons prior to relevant deadlines.

28. The UNCITRAL Model Law does not currently permit procuring entities to require use of electronic means by suppliers (articles 9 and 30). One of the main issues that falls to be considered is whether the use of electronic communications should be mandatory or optional: that is, whether the procuring entity and/or the suppliers or potential suppliers may insist on electronic or, indeed, paper means of communication. The Commission will wish to follow the principle that the means of communication imposed should not present an unreasonable barrier to access in considering this issue.

29. Other issues raised in paragraph 18 above concerning the advantages and disadvantages of a mandatory electronic regime may fall to be considered in this regard. It is noteworthy that the provisions dealing with authenticity, security and confidentiality (for example, if digital signatures are required) may involve significant costs to the parties. Further, whether the general legal environment in a State provides adequate support for using electronic means will be an important consideration. For example, laws on admissibility of evidence or formalities (such as signatures) for certain types of contract may refer only to non-electronic documents, or the law on issues such as the time and location of offer and acceptance in contract through electronic means may be unclear. The UNCITRAL Model Law on Electronic Commerce and the UNCITRAL Model Law on Electronic Signatures address certain of these issues.

## **F. Electronic (reverse) auctions**

30. The “reverse electronic auction” is an increasingly popular tendering process. A reverse auction is a tendering procedure for the procurement of products, works or services in which suppliers are provided with information on the other tenders, and can amend their own tenders on an ongoing basis in competition with the other tenders, normally without knowing the identity of other suppliers. In an electronic reverse auction suppliers then post tenders electronically through an electronic auction site, normally via the Internet (the use of which has largely superseded proprietary systems), using information on ranking or amount required to beat other suppliers’ offers. Suppliers can view in electronic form the progress of the tenders as the auction proceeds and amend their own tenders accordingly. The auction may

take place over a set time period, or may operate until a specified period has elapsed without a new tender.

31. Reverse auctions are most commonly used for standardized products and services for which price is the only, or at least a key, award criterion, since it is generally price alone that features in the “auction” process. However, other criteria can be used and can be built in to the auction phase, or evaluated in a separate phase in the overall procedure.

32. Recognition of the use and potential use of auctions and their positive effect on competition has led some States and international organizations to regulate or provide guidance on the method (that is, they address the technique explicitly). However, there are no equivalent provisions in many other States.

33. It has been noted that transparency would be increased if both information on other tenders and the outcome of the procedure were available to participants (see, further, the section entitled “Publication of contract awards”, at para. 23 above).

34. The UNCITRAL Model Law does not make express provision for the use of an electronic reverse auction. While some aspects of the process may be encompassed by existing provisions, others may not. Accordingly, in cases in which non-price criteria such as quality are rated separately prior to the auction, price and non-price criteria are then combined, using specialized auction software, with the information submitted in the auction so as to give each supplier’s overall standing at any time. Thus the overall procedure is a “two-stage” one, in which the first stage is the rating by the purchaser of the relevant non-price aspects and the second stage is the auction phase, in which the price and non-price aspects are combined to give an overall ranking.

35. It has been noted that the UNCITRAL Model Law’s general tendering procedure, “open tendering”, assumes a single tendering stage, and would not permit the process outlined above. Further, the practice of submitting tenders in writing in a sealed envelope is not compatible with an auction process. With regard to evaluation and comparison of tenders, article 34, paragraph 1 (a) of the UNCITRAL Model Law prohibits changes to the price of tenders after submission and that, under article 34, paragraph 8, information on tenders must not be disclosed, both of which constitute an obstacle to using electronic reverse auctions.

36. The Commission may therefore wish to consider whether there is a need to regulate electronic auctions, either as a version of traditional procurement methods or as a distinct method. It has been pointed out that treating such auctions as a version of traditional tendering would require the introduction of additional rules to address auctions’ special features relating to tender confidentiality and two-phase evaluation, but to do so may be more desirable than treating electronic auctions as a separate tendering method requiring novel and specific provisions.

37. The Commission may also wish to consider whether there is a need to address the above issues in the UNCITRAL Model Law and elsewhere. For example, and since an electronic auction might not be suitable for all States for technical or other reasons (as is also the case with certain other provisions, including the different evaluation methods for the procurement of services), consideration might be given to presenting it as an optional procedure.

38. The UNCITRAL Model Law is based on a general acknowledgement that the use of open tenders, restricted tenders and requests for quotations reflects best practice in domestic public procurement regulations. The Commission may wish to consider whether there is a need to provide guidance in the UNCITRAL Model Law for an auction procedure that follows the pattern of these methods, adapted to include an auction phase, but nonetheless consistent with the principles and objectives of the UNCITRAL Model Law.

### **G. Electronic catalogues**

39. Electronic catalogues can be electronic versions of traditional hard-copy catalogues or may incorporate electronic ordering facilities, and are in increasing use. In practice, a procuring entity may use an electronic catalogue arrangement as a means of identifying suppliers to receive quotations (or standing offers) and, de facto, have a similar effect to the operation of a mandatory qualification list or a multi-supplier framework agreement. Further comment on the question of electronic catalogues will therefore be made in the sections addressing those issues (see, further, paras. 48-56 and 73-75 below).

### **H. Conclusions and recommendations as regards the use of electronic communications in procurement**

40. The Commission will have noted that there are two main threads of the use of electronic communications in the field of procurement: communication by electronic means, and the use of the Internet for conducting a procurement process itself. The Commission may wish to consider whether, in view of the fact that the technology involved is developing rapidly, there is a need to provide legislative rules on the principles that govern methods of electronic procurement and communication in the UNCITRAL Model Law, rather than addressing the technology itself in that document. Further, the Commission may wish to review whether further guidance on the adoption and use of such methods in the law or elsewhere that may assist States with less sophisticated technologies or that do not (yet) have the required levels of access to the technology required could be provided.

## **IV. Possible additional points for review in the UNCITRAL Model Law**

41. The activities and experience of the international organizations and lending institutions in the area of government procurement are described in the Secretariat's notes A/CN.9/539 and A/CN.9/539/Add.1, and those notes observe that some institutions are currently in the process of reviewing their rules and regulations in the field of public procurement.

42. These activities and reviews reflect the growing importance of procurement regimes as a vehicle for national economic development and for regional and interregional cooperation and integration. Issues that will fall to be considered include the varying stages of economic and technological development of the

economies concerned, and how to address the aims of efficiency, effectiveness and transparency.

43. The Commission's aim of harmonization appears to confirm the desirability of ensuring that, to the extent possible and respecting its principles, the UNCITRAL Model Law is consistent with other international and regional public procurement regimes in use, and such harmonization should increase its use.

44. The secretariat addresses possible additional points for review arising from such matters in the following sections of this note.

#### **A. The use of suppliers' lists**

45. Suppliers' lists (also known as qualification lists, qualification systems or approved lists) identify selected suppliers for future procurements and can operate as either mandatory or optional lists. Mandatory lists require registration of the supplier on the list as a condition of participation in the procurement, whereas, in the case of optional lists, a supplier may choose to register without prejudice to eligibility. Admission of a supplier on a list may involve a full assessment of the supplier's suitability for certain contracts, some assessment or no assessment at all, but normally will involve an initial assessment of some qualifications, leaving others to be assessed when the supplier is considered for specific contracts.

46. The main purpose of suppliers' lists is to streamline the procurement process, leading to cost savings, wider competition, and more efficient information management, benefiting both purchasers and suppliers.

47. The advantages of optional lists include cost reductions from eliminating the need to provide and evaluate separate qualification information for each contract, access to information if emergency procurements are required, reduced costs for suppliers in finding contract information (which can be given automatically to registered suppliers), and potentially wider competition if lower supplier costs lead to increased numbers of interested suppliers. Lists can also save time by eliminating or reducing the period for advertising, awaiting expressions of interest, and assessing qualifications (of particular importance in the case of procurement that is not subject to advertisement and competition, such as urgent procurement, which is often carried out in an ad hoc way that favours suppliers known to the procuring entity).

48. In the practice of some countries, lists have been found to promote consistency and efficiency in procurement policy by encouraging standard questionnaires and qualification policies. The advantages are magnified when several purchasers use a common list, and common lists also enable entities to pool supplier information—for example, on unethical behaviour or reliability.

49. Mandatory suppliers' lists can increase the above advantages (that are largely those to the benefit of procuring entities), but also pose significant risks in potentially restricting competition by excluding suppliers from contracts (including those that would otherwise be subject to competitive tendering following an advertisement), if they compromise public confidence in public procurement by reducing transparency and promoting close relationships between suppliers and procuring entities. Their operation may also involve significant administrative costs.

50. Accordingly, the disadvantages of mandatory lists may outweigh the benefits. Nonetheless, they are used in many States and in international procurement regimes covering larger contracts. However, under these regimes their use is regulated: first, by limiting in some cases the entities that may use them and, secondly, by controlling their use to ensure they operate in a reasonable and transparent way.

51. It has been noted that the UNCITRAL Model Law does not address the subject of suppliers' lists, though it does not prevent procuring entities from using optional lists to choose suppliers in procurement that does not require advertising, such as restricted tendering, competitive negotiations, requests for proposals or quotations and single-source procurement. This use may in practice result in the exclusion of non-registered suppliers, such as by the use of the relatively informal request for quotations procedure, and operate effectively as a mandatory list.

52. At the time of the adoption of the UNCITRAL Model Law, the use of suppliers' lists was considered to be both undesirable and diminishing. However, with the spread of electronic communications, the use (and value) of lists has increased and their costs diminished. Further, it has been commented that increasing use of electronic catalogues may also lead to more procurement being conducted in a way that involves de facto reliance on suppliers' lists.

53. The use of suppliers' lists could provide a more transparent and non-discriminatory way of selecting suppliers for those restricted procurement methods in respect of which there is no control over the selection of suppliers in the UNCITRAL Model Law. The aim of such controls would be to ensure that fairer and more transparent access to the lists for suppliers is put into place and could, for example, consist of an obligation to publicize the existence of any list in accordance with any publication requirements governing future opportunities.

54. It has also been noted that the UNCITRAL Model Law does not allow procuring entities to restrict access to procurement to suppliers registered on lists (i.e. to operate mandatory lists), in that article 6 (3) prohibits entities from imposing any "criterion, requirement or procedure" other than those in article 6, and article 6 does not refer to registration on a list.

55. Many international lending institutions do not regard the use of mandatory lists as good practice so far as open tender procedures are concerned. However, some States continue to use mandatory lists, and the Commission may therefore wish to consider whether legislative guidance on operating them in the UNCITRAL Model Law or the Guide to Enactment may be needed.

56. It is also arguable that an advertised and regulated mandatory list can provide for fairer and more transparent access for suppliers in certain types of procurement, as is noted with regard to optional lists above. To allow States a regulated mandatory list option could improve competition and transparency in those circumstances.

## **B. Procurement of services**

57. The current "principal method for procurement of services" under chapter IV of the UNCITRAL Model Law is flexible, in that it incorporates flexible

procurement methods, which can involve negotiation, for selecting the winner after submission of suppliers' proposals.

58. The UNCITRAL Model Law also provides that tendering should be used for the procurement of services when it is feasible to formulate detailed specifications and tendering is considered "appropriate". Otherwise, other methods for procuring goods and construction may be used if to do so would be more appropriate, and if conditions for their use are satisfied (article 18 (3)).

59. The premise of the UNCITRAL Model Law is that procurement of services will be undertaken using different methods from the procurement of goods and construction. It has been noted, however, that the flexible approach to evaluation (employing qualitative and negotiated methods) is, in practice, used only for certain types of services procurement. A notable example is the selection of intellectual services (that is, services that do not lead to measurable physical outputs, such as consulting and other professional services). It has also been suggested that the procurement of services measurable on the basis of physical outputs could employ the rigorous and objective selection methods applied to the procurement of goods and construction. Paragraph 9 of the Secretariat's note A/CN.9/539/Add.1 provides more detail as to the suggestions made in this regard.

60. The Commission may wish to consider, therefore, whether amendment to certain provisions of the UNCITRAL Model Law may be required, so as to provide for a more rigorous regime for the procurement of many services, and to give greater flexibility to the procurement of intellectual services.

### **C. Alternative methods of procurement**

61. Suggestions have been made by at least one multilateral lending institution that it might be useful to review the need and conditions of use of some of the "alternative methods of procurement" set out in chapter V of the UNCITRAL Model Procurement Law. Details as to suggestions made to the Secretariat in this regard are found in paragraph 11 of the Secretariat's note A/CN.9/539/Add.1.

62. The Commission may wish to note, however, that extensive consideration was given to these issues during the preparation of the UNCITRAL Model Law. It may wish to consider therefore whether such issues should be further addressed.

### **D. Community participation in procurement**

63. The UNCITRAL Model Law does not address the contract implementation phase of a procurement project. One aspect of such implementation that has been brought to the attention of the Secretariat is the notion of community participation (that is, the end-users are involved in the implementation of a project). Community participation has been noted by one international lending institution to be the most efficient way to implement a project, because the users have an incentive to ensure good quality in the performance of work affecting them directly.

64. Community participation is provided for in a number of modern procurement systems in which the selection method is used for the purpose of achieving social

goals and a sustainable delivery of services in sectors unattractive to larger companies such as health, agricultural extension services and informal education.

65. Provision is sometimes made for such participation in national procurement rules, in that the selection of the method of procurement or award criteria may allow community participation to be considered, or alternatively as a condition of the contract or contracts ultimately awarded. The Secretariat understands that there are variations in the way community participation in procurement takes place, allowing for the utilization of local know-how and materials, and the employment of labour-intensive technologies, among others.

66. The UNCITRAL Model Law does not specifically address the issue of community participation, but its provisions are sufficiently flexible to allow most of the arrangements set out in the preceding paragraphs be put in place. However, the Commission may wish to consider whether express provision for community participation to be included in the selection of a procurement method or award criteria may be needed.

67. The Secretariat also understands that certain methods of allowing for community participation in procurement contracts involve the subdivision of contracts or the award of small contracts often using single-source procurement. These methods would not be permissible under the UNCITRAL Model Law as it currently stands, and the Commission may wish to consider whether provision in the UNCITRAL Model Law is necessary for such procedures to be adopted, whether it may be necessary to comment on their adoption in the Guide to Enactment and whether giving enacting States a possibility to make appropriate exceptional provisions in their domestic legislation may be needed.

## **E. Framework agreements**

68. “Framework agreements” can be defined as agreements for securing the repeat supply of a product or service over a period of time, which involve a call for initial tenders against set terms and conditions, and selection of one or more suppliers on the basis of the tenders, and the subsequent placing of periodic orders with the supplier(s) chosen as particular requirements arise. Their main use therefore arises in circumstances in which procuring entities require particular products or services over a period of time but do not know the exact quantities that they will need.

69. Observers have noted that many national laws on procurement contain provisions on framework agreements, or equivalent procedures that operate under alternative nomenclature. The main reason for using this type of arrangement, rather than commencing a new award procedure for every requirement, is to save on the procedural costs of procurement. In particular, such an arrangement avoids the need to advertise and the assessment of suppliers’ qualifications for every order placed, as this phase of the process is done once only at the initial stage described above.

70. The UNCITRAL Model Law contains no specific provisions on framework agreements.

71. Framework agreements are widely used in many States and in some cases are regulated by national law (as well as being in some cases subject to the rules of regional bodies or international lending institutions). The methods of procurement

available for operating framework agreements often depend on the general rules on financial thresholds (that is, thresholds below which non-open tendering procedures may be used) and on how, if at all, the rules on thresholds are adapted for framework agreements. Those thresholds may depend simply on the value of each contract or may involve some degree of aggregation.

72. Framework agreements may be concluded with a single supplier or multiple suppliers. Single-supplier agreements may bind the procuring entity to purchase, bind the supplier to supply, or both, or may bind neither party but set the terms for contracts to be awarded in the future, with a legal commitment arising only when an order is agreed.

73. Multi-supplier arrangements involve an initial competition to select several potential suppliers that can supply the products or services on terms and conditions set out by the procuring entity (the first award phase). When a requirement subsequently arises for the product or service, the procuring entity then chooses from these suppliers a supplier for that particular order (the second award phase).<sup>7</sup> The methods used for the selection of the supplier(s) in the second award phase vary widely among the States that use them, notably in that the degree of further competition varies significantly. The balance of the aims of use of competition (so as to promote value for money), openness and transparency in the approaches chosen as against the procedural costs of the methods themselves is reflected in these variations.

74. The main benefits of using multi-supplier rather than single supplier agreements include flexibility in the selection of a supplier for a specific order, avoiding the costs of a whole new procedure, the security of supply, the advantages of centralized purchasing, and enhanced access to government work for smaller suppliers. They can also enhance value for money and other procurement objectives by providing a more transparent procedure than would otherwise exist for small purchases. In particular, aggregation of contract amounts under a framework agreement may justify costs of advertising, and framework suppliers have an interest in monitoring the operation of purchases under the arrangement (by contrast with a supplier under a single-supplier framework).

75. Although the UNCITRAL Model Law does not address framework agreements expressly, some single-supplier and perhaps some multi-supplier agreements could be operated under existing procedures. Given their increasing use, and noting that other regional bodies (including the European Union) do address them, the Commission may wish to review whether provision for them in its Model Law is necessary.

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<sup>7</sup> The distinction between a multi-supplier framework and a supplier list or electronic catalogue is that with a framework more of the process is completed in the first phase. At this time most or all of the terms are generally agreed, there is a full assessment of suppliers' qualifications, and there is some initial selection between interested suppliers based on sample tenders.



## **F. Evaluation and comparison of tenders**

76. Evaluation criteria as regards tenders are set out in article 34, paragraph 4, of the UNCITRAL Model Law, and it is provided that the criteria for determining the lowest evaluated tender may allow for the use of procurement to promote industrial, social or environmental objectives. Such objectives may include the promotion of national industrial development (through the exclusion of a supplier, the granting of preferences and the use of single source procurement in limited circumstances). The award criteria may also allow for foreign exchange impacts to be taken into account. There are express control mechanisms to ensure that the award criteria remain objective, quantifiable, and disclosed in advance to suppliers.

77. A common comment made to the Secretariat is that the use of procurement to promote industrial, social or environmental objectives should be acknowledged in the UNCITRAL Model Procurement Law, so as to increase transparency and allow for greater control of their operation. Furthermore, the notion of regional as well as national objectives of that sort may also be considered.

78. In summary, it has been suggested to the Secretariat that certain provisions in article 34, paragraph 4, may be revised with such aims in mind, and that transparency would also be enhanced if express tender evaluation criteria were set out in its subparagraph (b), in monetary terms or in the form of requirements that the supplier must meet in order for its proposal to be considered acceptable for evaluation purposes. Further details of the suggestions made are found in paragraphs 25-30 of the Secretariat's note A/CN.9/539/Add.1.

79. The Commission may wish to consider whether revisions of these provisions may be appropriate, perhaps in the UNCITRAL Model Law itself, or whether appropriate guidance may be provided elsewhere, such as in the Guide to Enactment.

## **G. Remedies and enforcement**

80. It is generally accepted that an effective system for monitoring and enforcing substantive rules is an important element of a transparent procurement system. However, there is less consensus on the scope of protests and remedies available to a tenderer, applicable standards and whether review should be carried out by an administrative or judicial body.

81. The UNCITRAL Model Law's provisions are found in articles 52-57, but it is noted that in the Guide enacting States might not incorporate all or some of the articles. Further, relatively limited standards are provided for administrative review, even when no judicial review exists. These notes underline the particular sensitivity of the provisions at the time of the adoption of the provisions. However, it has been brought to the Secretariat's attention that the use of protests and remedies in procurement has become more acceptable and widespread as a result, *inter alia*, of the impact of international trade regimes (which now impose review obligations on many more countries than previously) and the policies of the various international lending institutions.

82. The Commission may wish to consider, therefore, whether there is a need for the UNCITRAL Model Law to provide both a clear endorsement of the desirability of and also more detailed guidance on how to achieve an adequate review system. Further detail of certain suggestions with regard to provisions that may be considered appropriate are set out in paragraphs 33-37 of the Secretariat's note A/CN.9/539/Add.1.

## **V. Other points for consideration**

83. Further detail of certain suggestions with regard to provisions that the Commission may consider to be appropriate for further review are set out in paragraphs 38-42 of the Secretariat's note A/CN.9/539/Add.1. They include the qualification of suppliers, rules regarding documentary evidence provided by suppliers, inducements from suppliers and contractors, contents of solicitation documents and guidance as regards the extent to which the UNCITRAL Model Procurement Law satisfies the requirements of the WTO Government Procurement Agreement, which could play a role in facilitating and promoting accessions to that Agreement.

84. In considering the issues set out in this note, the Commission may consider that some consequential revisions of the text of the UNCITRAL Model Law may be desirable. Given the differing stages of development of the States that will use the Model Law, and the possible inclusion of alternative or optional provisions, some simplification of certain provisions may also be helpful.

## **VI. Conclusions and recommendations**

85. The body of this note sets out aspects of the area of public procurement that may, in the Commission's opinion, merit consideration at this juncture, some of which might involve the formulation of best practices, model contractual clauses and other forms of practical advice, in addition or as an alternative to legislative guidance. Such consideration would not be intended to re-open issues that were fully dealt with in the discussions leading to the adoption of the UNCITRAL Model Law, but to assess the opportunity of adjusting the UNCITRAL Model Law in the light of new developments and practices (notably electronic procurement) or to deal with issues that were not discussed at that time.

86. As to the resources needed for any further work that the Commission may find appropriate, the Commission may recall that Working Group I has completed its work in the area of privately financed infrastructure projects, and could be convened in the third quarter of 2004, if the Commission were to so decide at its thirty-seventh session. Possible dates for the next meeting of the Working Group appear in section 17 of the provisional agenda (A/CN.9/541). The Commission may also wish to determine that Working Group I should cooperate closely with Working Group IV (Electronic Commerce) as regards the electronic commerce aspects of procurement legislation.

## VII. CASE LAW ON UNCITRAL TEXTS (CLOUT)

The Secretariat of the United Nations Commission on International Trade Law (UNCITRAL) continues publishing court decisions and arbitral awards that are relevant to the interpretation or application of a text resulting from the work of UNCITRAL. For a description of CLOUT (Case Law on UNCITRAL Texts), see the Users Guide (A/CN.9/SER.C/GUIDE/1), published in 1993.

A/CN.9/SER.C/ABSTRACTS may be obtained from the UNCITRAL Secretariat at the following address:

UNCITRAL Secretariat  
P.O. Box 500  
Vienna International Centre  
A-1400 Vienna  
Austria

Telephone (+43-1) 26060-4060 or 4061  
Telex: 135612 uno a  
Telefax: (+43-1) 26060-5813  
E-mail: [uncitral@uncitral.org](mailto:uncitral@uncitral.org)

They may also be accessed through the UNCITRAL homepage on the Internet at [www.uncitral.org](http://www.uncitral.org).

Copies of complete texts of court-decisions and arbitral awards, in the original language, reported on in the context of CLOUT are available from the Secretariat upon request.



## VIII. TRAINING AND ASSISTANCE

### Note by the Secretariat on training and technical assistance (A/CN.9/560) [Original:English]

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### I. Introduction

1. Pursuant to a decision taken at the twentieth session of the United Nations Commission on International Trade Law (UNCITRAL),<sup>1</sup> held in 1987, training and assistance activities count among the high priorities of UNCITRAL. The training and technical assistance programme carried out by the Secretariat under the mandate given by the Commission, in particular in developing countries and in countries with economies in transition, encompasses two main lines of activity: (a) seminars and briefing missions aimed at promoting understanding of international commercial law conventions, model laws and other legal texts; and (b) assistance to Member States with commercial law reform and adoption of UNCITRAL texts. As the ultimate goal of these activities is the adoption of UNCITRAL texts, they are an integral part of the Commission's legislative work.

2. The present note lists the activities of the Secretariat subsequent to the issuance of the previous note submitted to the Commission at its thirty-sixth

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<sup>1</sup> *Official Records of the General Assembly, Forty-second Session, Supplement No. 17 (A/42/17)*, para. 335.

session, in 2003 (A/CN.9/536 of 14 May 2003), and indicates possible future training and technical assistance activities in the light of the requests for such services from the Secretariat. The note also sets out proposals regarding technical legislative assistance in light of the decision to expand the Secretariat discussed below (see paras. 3-5).

## II. New resources for the UNCITRAL Secretariat

3. The Commission may recall that at its thirty-sixth session, it noted the remarks made by the Office of Internal Oversight Services, in its report on the in-depth evaluation of legal affairs (E/AC.51/2002/5, para. 64), with respect to the effectiveness of the training and assistance provided by the Secretariat and the concern that, without follow-up actions and effective cooperation and coordination between the Secretariat and development assistance agencies providing or financing technical assistance, international assistance might lead to the adoption of national laws that did not represent internationally agreed standards. In that connection, the Commission noted with appreciation the initial steps taken to implement the request of the General Assembly that the Secretary-General increase substantially both the human and the financial resources available to the Secretariat, part of which would be used to ensure the effective implementation of the technical legislative assistance programme of the Commission and the timely publication and dissemination of its work.<sup>2</sup>

4. The Commission may wish to note that in December 2003, the General Assembly approved additional human resources for the Secretariat of UNCITRAL (three professional officers) to enable the Secretariat to carry out functions with respect to technical legislative assistance, dissemination of information on legal developments in the field of international trade law and to coordinate the work of international organizations active in the field of international trade effectively and in a timely fashion. One of these additional positions has already been filled by a lateral transfer from New York and the other two positions are currently being advertised with a view to completing the recruitment process as soon as possible.

5. Once this recruitment action is completed, the Secretariat proposes devising a plan to address the ways in which the functions outlined above could be developed, and a timetable for implementation. In consultation with Permanent Missions in Vienna and New York, for example, the Secretariat may work to identify law reform needs and associated assistance requirements in the area of international trade law and, in consultation with relevant international, regional and national organizations, to identify opportunities for developing joint programmes, or for UNCITRAL participation in existing programmes related to technical assistance with law reform in the area of international trade law. It is anticipated that other initiatives will include development of materials on UNCITRAL and UNCITRAL texts to facilitate the provision of technical legislative assistance, as well as strategies to enhance coordination of the work of, and cooperation between, other organizations active in the field of international trade law. The Commission may wish to discuss the

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<sup>2</sup> *Ibid.*, *Fifty-eighth Session, Supplement No. 17 (A/58/17)*, para. 251 and also see paras. 256-261.

development of this work to provide guidance to the Secretariat on policy issues and priorities.

### **III. Extrabudgetary funding**

6. Given the importance of extrabudgetary funding for the implementation of the training and technical assistance component of the UNCITRAL work programme, the Commission may again wish to appeal to all States, international organizations and other interested entities to consider making contributions to the Trust Fund for UNCITRAL symposiums, if possible in the form of multi-year contributions, so as to facilitate planning and to enable the Secretariat to meet the increasing demands from developing countries and States with economies in transition for training and legislative assistance. Information on how to make contributions may be obtained from the Secretariat.

7. In the period under review, contributions were received from France, Greece, Mexico and Switzerland. The Commission may wish to express its appreciation to those States and organizations which have contributed to the Commission's programme of training and assistance by providing funds or staff or by hosting seminars.

8. In that connection, the Commission may wish to recall that, in accordance with General Assembly resolution 48/32 of 9 December 1993, the Secretary-General was requested to establish a Trust Fund to grant travel assistance to developing countries that are members of UNCITRAL. The Trust Fund so established is open to voluntary financial contributions from States, intergovernmental organizations, regional economic integration organizations, national institutions and non-governmental organizations, as well as to natural and juridical persons.

9. Since the establishment of the Trust Fund, contributions have been received from Austria, Cambodia, Cyprus, Kenya and Mexico.

10. It is recalled that in its resolution 51/161 of 16 December 1996, the General Assembly decided to include the Trust Funds for UNCITRAL symposiums and travel assistance in the list of funds and programmes that are dealt with at the United Nations Pledging Conference for Development Activities.

11. In order to ensure full participation of all Member States in the sessions of UNCITRAL and its Working Groups, the Commission may wish to reiterate its appeal to the relevant bodies in the United Nations system, organizations, institutions and individuals to make voluntary contributions to the Trust Fund established to provide travel assistance to developing countries that are members of the Commission.

### **IV. Importance of texts of the United Nations Commission on International Trade Law**

12. Increasing importance is being attributed by Governments, international organizations, including multilateral and bilateral aid agencies, and the private sector to improvement of the legal framework for international trade and

investment. UNCITRAL has an important function to play in that process because it produces and promotes the use of legal instruments in a number of key areas of commercial law that represent internationally agreed standards and solutions acceptable to different legal systems. Those instruments include:

(a) In the area of sales, the United Nations Convention on Contracts for the International Sale of Goods<sup>3</sup> and the United Nations Convention on the Limitation Period in the International Sale of Goods;<sup>4</sup>

(b) In the area of dispute resolution, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards<sup>5</sup> (a United Nations convention adopted prior to the establishment of the Commission, but actively promoted by it), the UNCITRAL Arbitration Rules,<sup>6</sup> the UNCITRAL Conciliation Rules,<sup>7</sup> the UNCITRAL Model Law on International Commercial Arbitration,<sup>8</sup> the UNCITRAL Notes on Organizing Arbitral Proceedings,<sup>9</sup> and the UNCITRAL Model Law on International Commercial Conciliation;<sup>10</sup>

(c) In the area of government contracting, the UNCITRAL Model Law on Procurement of Goods, Construction and Services<sup>11</sup> and the UNCITRAL Legislative Guide on Privately Financed Infrastructure Projects;<sup>12</sup>

(d) In the area of banking, payments and insolvency, the United Nations Convention on the Assignment of Receivables in International Trade (General Assembly resolution 56/81, annex), the United Nations Convention on Independent Guarantees and Standby Letters of Credit (General Assembly resolution 50/48, annex), the UNCITRAL Model Law on International Credit Transfers,<sup>13</sup> the United Nations Convention on International Bills of Exchange and International Promissory Notes (resolution 43/165, annex) and the UNCITRAL Model Law on Cross-Border Insolvency;<sup>14</sup>

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<sup>3</sup> *Official Records of the United Nations Conference on Contracts for the International Sale of Goods, Vienna, 10 March-11 April 1980* (United Nations publication, Sales No. E.82.V.5), part I.

<sup>4</sup> *Official Records of the United Nations Conference on Prescription (Limitation) in the International Sale of Goods, New York, 20 May-14 June 1974* (United Nations publication, Sales No. E.74.V.8), part I.

<sup>5</sup> United Nations, *Treaty Series*, vol. 330, No. 4739.

<sup>6</sup> *Official Records of the General Assembly, Thirty-first Session, Supplement No. 17 (A/31/17)*, para. 57.

<sup>7</sup> *Ibid.*, *Thirty-fifth Session, Supplement No. 17 (A/35/17)*, para. 106.

<sup>8</sup> *Ibid.*, *Fortieth Session, Supplement No. 17 (A/40/17)*, annex I.

<sup>9</sup> *Ibid.*, *Fifty-first Session, Supplement No. 17 (A/51/17)*, chap. II.

<sup>10</sup> *Ibid.*, *Fifty-seventh Session, Supplement No. 17 (A/57/17)*, annex I.

<sup>11</sup> *Ibid.*, *Forty-ninth Session, Supplement No. 17 and corrigendum (A/49/17 and Corr.1)*, annex I.

<sup>12</sup> United Nations publication, Sales No. E.01.V.4.

<sup>13</sup> *Official Records of the General Assembly, Forty-seventh Session, Supplement No. 17 (A/47/17)*, annex I.

<sup>14</sup> *Ibid.*, *Fifty-second Session, Supplement No. 17 (A/52/17)*, annex I.



(e) In the area of transport, the United Nations Convention on the Carriage of Goods by Sea, 1978 (Hamburg Rules),<sup>15</sup> and the United Nations Convention on the Liability of Operators of Transport Terminals in International Trade;<sup>16</sup> and

(f) In the area of electronic commerce and data interchange, the UNCITRAL Model Law on Electronic Commerce<sup>17</sup> and the UNCITRAL Model Law on Electronic Signatures.<sup>18</sup>

## V. Technical assistance in the preparation and implementation of legislation

13. Technical assistance is provided to States preparing legislation based on UNCITRAL texts. Such assistance is provided in various forms, including review of preparatory drafts of legislation from the viewpoint of UNCITRAL texts, technical consultancy services and assistance in the preparation of legislation based on UNCITRAL texts, preparation of regulations implementing such legislation and comments on reports of law reform commissions, as well as briefings for legislators, judges, arbitrators, procurement officials and other users of UNCITRAL texts embodied in national legislation. Another form of technical assistance provided by the Secretariat consists of advising on the establishment of institutional arrangements for international commercial arbitration, including training seminars for arbitrators, judges and practitioners in the area. Training and technical assistance promotes awareness and wider adoption of the legal texts produced by the Commission and is particularly useful for developing countries lacking expertise in the areas of trade and commercial law covered by the work of UNCITRAL. Commercial law reform, based on harmonized international instruments, has a clear impact on the ability of enterprising persons in all States to participate in international trade. This trade plays an important part in increasing the well-being of their societies and is an important factor in achieving sustainable development and social stability. The training and technical assistance activities of the Secretariat could thus play an important role in the economic integration efforts being undertaken by many countries.

14. In its resolution 58/75 of 8 January 2004, the General Assembly reaffirmed the importance, in particular for developing countries, of the work of the Commission concerned with training and technical assistance in the field of international trade law and reiterated its appeal to the United Nations Development Programme and other bodies responsible for development assistance, such as the World Bank and regional development banks, as well as to Governments in their bilateral aid

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<sup>15</sup> *Official Records of the United Nations Conference on the Carriage of Goods by Sea, Hamburg, 6-31 March 1978* (United Nations publication, Sales No. E.80.VIII.1), document A/CONF.89/13, annex I.

<sup>16</sup> A/CONF.152/13, annex.

<sup>17</sup> *Official Records of the General Assembly, Fifty-first Session, Supplement No. 17* (A/51/17), annex I.

<sup>18</sup> *Ibid.*, *Fifty-sixth Session, Supplement No. 17* (A/56/17), annex II.

programmes, to support the training and technical assistance programme of the Commission and to cooperate and coordinate their activities with those of the Commission.

15. In the same resolution, the General Assembly stressed the importance of bringing into effect the conventions emanating from the work of the Commission for the global unification and harmonization of international trade law, and to this end urged States that have not yet done so to consider signing, ratifying or acceding to those conventions.

16. The UNCITRAL Secretariat is prepared to provide technical assistance and advice to States considering signature, ratification or accession to UNCITRAL conventions, as well as to States that are in the process of revising their trade legislation.

## **VI. Seminars and briefing missions**

17. The activities of UNCITRAL are typically carried out through seminars and briefing missions for government officials from interested ministries (such as trade, foreign affairs, justice and transport), judges, arbitrators, practising lawyers, the commercial and trading community, scholars and other interested individuals. Seminars and briefing missions are designed to explain the salient features and utility of international trade law instruments of UNCITRAL. Information is also provided on certain important legal texts of other organizations, for example, Uniform Customs and Practice for Documentary Credits and Incoterms of the International Chamber of Commerce.

18. Lectures at UNCITRAL seminars are generally conducted by one or two members of the UNCITRAL Secretariat, experts from the host countries and, occasionally, external consultants. After the seminars, the Secretariat maintains contact with seminar participants in order to provide the host countries with the maximum possible support during the process leading up to the adoption and use of UNCITRAL texts.

19. Since the previous session, the Secretariat of the Commission has organized seminars in a number of States, which have typically included briefing missions. The following seminars were financed with resources from the Trust Fund for UNCITRAL symposiums (numbers of participants are approximate only):

(a) Lima (19-21 May 2003), seminar held in cooperation with the Inter-American Bar Association (120 participants);

(b) Ulan Bator (26-28 May 2003), seminar held in cooperation with the Government of Mongolia and the Mongolian Chamber of Commerce (60 participants);

(c) Belgrade (6-7 June 2003), seminar held in cooperation with the European Center for Peace and Development of the University of Peace (15 participants);

(d) Auckland, New Zealand (10-12 June 2003), seminar held in cooperation with the Ministry of Foreign Affairs and Trade for Small Pacific States (20 participants);

- (e) Gaborone (9-10 September 2003), seminar held in cooperation with the Government of Botswana and the United Nations Development Programme (UNDP) Botswana (80 participants);
- (f) Seoul (24-26 September 2003), seminar held in cooperation with the Ministry of Justice (70 participants);
- (g) Vladivostok, Russian Federation (29 September-1 October 2003), seminar held in cooperation with the Chamber of Commerce and Industry of the Russian Federation (50 participants);
- (h) Havana (29 September-3 October 2003), seminar held in cooperation with the Cuban Society for Law and Information Technology of the National Union of Cuban Jurists (250 participants);
- (i) Caracas (19-21 November 2003), seminar held in cooperation with the Government of Venezuela (120 participants);
- (j) Bogota (25-28 November 2003), seminar held in cooperation with the Government of Colombia (300 participants);
- (k) Khartoum (26-29 January 2004), seminar held in cooperation with the Government of Sudan (60 participants);
- (l) Belgrade (5-7 February 2004), seminar held in cooperation with the European Center for Peace and Development of the University of Peace (10 participants); and
- (m) Sanaa (8-10 March 2004), seminar held in cooperation with the Ministry of Justice and the Yemen Arbitration Centre (110 participants).

## VII. Participation in other activities

20. Members of the UNCITRAL Secretariat have participated as speakers in various seminars, conferences and courses where UNCITRAL texts were presented for examination and possible adoption or use. The participation of members of the Secretariat in the seminars, conferences and courses listed below was financed by the institution organizing the events or by another organization. Participation to some of those seminars, conferences and courses was financed, partially or totally, with resources from the United Nations regular travel budget:

- (a) London Court of International Arbitration (LCIA) European Council Symposium (interim measures of protection in arbitration) (London, 5-9 May 2003);
- (b) Permanent Court of Arbitration and International Centre for Dispute Resolution Forum (interim measures of protection in arbitration) (Brussels, 28 May 2003);
- (c) Colloquium on International Commercial Arbitration and African States (London, 4-5 June 2003);
- (d) Comité Maritime International (CMI) Colloquium (Bordeaux, France, 11-13 June 2003);
- (e) UN/CEFACT Legal Working Group (Geneva, 16-17 June 2003);

- (f) Information Session for WTO Members on Government Procurement (Geneva, 19 June 2003);
- (g) UNCTAD Regional High Level Conference for Africa on Electronic Commerce Strategies for Development (Tunis, 19-21 June 2003);
- (h) Alternative Dispute Resolution Conference: Alternative Resolution of Civil and Commercial Disputes in the Global Business Environment (Rome, 3 July 2003);
- (i) Undergraduate Student Summer School Programme sponsored by the University of Economics and Law, Hamburg, and the University of Technology, Sydney (Hamburg, 21-22 July 2003);
- (j) E-Commerce Current Commercial Law Workshop sponsored by the University of Pretoria (Pretoria, 28 August 2003);
- (k) International Bar Association Annual Conference (San Francisco, California, United States of America, 18-19 September 2003);
- (l) International Multi-National Judicial Colloquium sponsored by UNCITRAL and the International Federation of Insolvency Professionals (INSOL) and INSOL Annual Regional Conference (Las Vegas, Nevada, United States of America, 20-23 September 2003);
- (m) Postgraduate Programme Lectures on International Trade Law sponsored by the Federal University of Rio Grande do Sul (Porto Alegre, Brazil, 29 September-2 October 2003);
- (n) Insolvency Symposium 2003 sponsored by the European Central Bank (Frankfurt, Germany, 30 September-1 October 2003);
- (o) UNCTAD/ECE High Level Regional Conference for Transition Economies on "ICT and E-Commerce Strategies for Development" (Geneva, 20-21 October 2003);
- (p) New York State Bar Association Programme on Receivables, Mobile Equipment and Securities sponsored by the New York State Bar Association, the International Bar Association and Union Internationale des Avocats (Amsterdam, 24 October 2003);
- (q) USAID Commercial Dispute Project Conference on the Use of Mediation in Countries of South East Europe (Ljubljana, 27-29 October 2003);
- (r) International Conference on Secured Transactions sponsored by the Law School of the University of Manchester (Manchester, United Kingdom, 29-30 October 2003);
- (s) Electronic Commerce Seminar sponsored by Ecole De Hautes Etudes Commerciales du Nord (EDHEC) (Nice, France, 6-7 November 2003);
- (t) OECD Forum for Asian Insolvency Reform (Seoul, 10-11 November 2003);
- (u) UNIDROIT Study Group S78 and Colloquium on Harmonized Substantive Rules Regarding Securities Held with an Intermediary (Rome, 12-14 November 2003);

(v) Comité Maritime International (CMI) International Sub-Committee on Issues of Transport Law (London, 17 November 2003);

(w) Commercial Dispute Resolution Symposium sponsored by USAID (Moscow, 19-21 November 2003);

(x) Conference on Cross-Border Security for Credit sponsored by the Academy of European Law (Trier, Germany, 4-5 December 2003);

(y) Conference on Commercial Mediation and Arbitration in Croatia and the Balkan Region sponsored by the Croatian Chamber of Commerce (Zagreb, 4 December 2003);

(z) Conference on Contractual Rights and Obligations in Central and South-eastern Europe and the Commonwealth of Independent States sponsored by the European Bank for Reconstruction and Development (EBRD) (London, 5 December 2003);

(aa) International Chamber of Commerce (ICC) Commission on Banking Technique and Practice and ICC International Conference on Banking and Trade Finance (New Delhi, 9-11 December 2003);

(bb) E-Commerce Conference and Judicial Colloquium sponsored by the Cairo Regional Centre for International Commercial Arbitration (Cairo, 17-19 January 2004);

(cc) Conference on “The New Swiss Rules for International Arbitration” sponsored by the Swiss Arbitration Association (Zurich, Switzerland, 23 January 2003);

(dd) Conference on Balancing Recovery, Restructuring and Liquidation—Emerging Challenges in Asia sponsored by INSOL India and Business Recovery and Insolvency Professionals of Sri Lanka (Colombo, 13-15 February 2004);

(ee) Comité Maritime International (CMI)/UNCITRAL Roundtable on Freedom of Contract (London, 20-21 February 2004);

(ff) Moroccan Ministry of Justice Discussion Seminar on its Draft Arbitration Law, Casablanca, Morocco, 3-4 March 2004);

(gg) Congress on the management of conflicts—new perspectives and methodologies in conciliation (Turin, 5 March 2004);

(hh) Good Governance Consortium, European Union Regional Planning Meeting (Vienna, 5 March 2004);

(ii) Electronic Signatures—Advancing E-Commerce in Egypt Conference under the auspices of the Ministry of Communication and Information Technology, Egypt, sponsored by the United States Department of Commerce and USAID (Cairo, 27-28 March 2004);

(jj) International Trade Law Postgraduate Course, sponsored by the International Training Centre of the International Labour Organization (ILO) and the University Institute of European Studies (Turin, Italy, 2 April 2004); and

(kk) Joint Conference: Current and Future Work of UNCITRAL on International Commercial Arbitration—Partners in Europe: Arbitration in Central

and Eastern European Countries sponsored by UNCITRAL and the International Arbitral Centre of the Austrian Federal Economic Chamber (Vienna, 1-2 April 2004).

21. For the remainder of 2004, seminars and legal assistance briefing missions are being planned in Africa, Asia and Eastern Europe. Since the travel cost of training and technical assistance activities is not covered by the regular budget, the ability of the Secretariat to implement those plans is contingent upon the receipt of sufficient funds in the form of contributions to the Trust Fund for UNCITRAL symposiums.

22. As it has done in recent years, the Secretariat has agreed to co-sponsor the next three-month international trade law postgraduate course to be organized by the University Institute of European Studies and the International Training Centre of ILO in Turin. Typically, approximately half the participants are from Italy, with many of the remainder coming from developing countries. The contribution from the UNCITRAL Secretariat to the next course will focus on issues of harmonization of laws on international trade law from the perspective of UNCITRAL, including past and current work. It is hoped that at least one student from the course will participate in the United Nations internship programme with UNCITRAL. The internship programme is discussed below in paragraphs 24-25.

23. Also, as it has done for the past seven years, the Secretariat co-sponsored the tenth Willem C. Vis International Commercial Arbitration Moot in Vienna from 2 to 8 April 2004. The Moot is principally organized by the Institute of International Commercial Law at Pace University School of Law. With its broad international participation, involving 136 teams from 42 countries in 2004, it is seen as an excellent way to disseminate information about uniform law texts and teaching international trade law. As in the past, the Secretariat offered lectures to participants of the Moot.

## **VIII. Internship programme**

24. The internship programme is designed to give young lawyers the opportunity to become familiar with the work of UNCITRAL and to increase their knowledge of specific areas in the field of international trade law. During the past year, the Secretariat has hosted nine interns from Argentina, Mexico, Sweden, Trinidad, Tunisia and Venezuela. Interns are assigned tasks such as basic or advanced research, collection and systematization of information and materials or assistance in preparing background papers. The experience of UNCITRAL with the internship programme has been positive. However, as no funds are available to the Secretariat to assist interns to cover their travel or other expenses, interns have to be sponsored by an organization, university or government agency, or to meet their expenses from their own means. As a result, there is limited participation of interns from developing countries. In that connection, the Commission may wish to invite Member States, universities and other organizations, in addition to those which already do so, to consider sponsoring the participation of young lawyers, in particular from developing countries, in the United Nations internship programme with UNCITRAL.

25. The Secretariat also occasionally accommodates requests by scholars and legal practitioners who wish to conduct research in the UNCITRAL law library for a limited period of time.





## **IX. STATUS OF UNCITRAL TEXTS**

### **Status of conventions and model laws**

**(A/CN.9/561) [Original: English]**

Not reproduced. The updated list may be obtained from the UNCITRAL Secretariat or found on the Internet at *www.uncitral.org*.



## X. COORDINATION AND COOPERATION

### A. Note by the Secretariat on coordination of work: activities of international organizations in the area of security interests

(A/CN.9/565) [Original: English]

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## **I. Introduction**

1. The Commission, at its fourteenth session, decided that to further strengthen the coordinating role of the Commission, the Secretariat should select, at appropriate intervals, a particular area for consideration and should submit a report on the work of other organizations in that area!<sup>1</sup> Last year, the Secretariat selected the law of procurement of goods, construction and services for such a discussion by the Commission (see A/CN.9/539 and Add.1). This year the area selected is security interests.

2. The purpose of this paper is to provide and disseminate information on the activities of international organizations in respect of security interests with a view to facilitating coordination of current activities of various organizations and clarifying the relationship among completed texts.

## **II. Current activities of international and regional organizations in the area of security interests**

### **A. UNCITRAL**

#### **1. The United Nations Convention on the Assignment of Receivables in International Trade**

3. In 2001, the General Assembly of the United Nations adopted the United Nations Convention on the Assignment of Receivables in International Trade (hereinafter referred to as “the United Nations Assignment Convention”). The United Nations Assignment Convention removes legal obstacles to the assignment of receivables, provides a uniform set of rules with respect to the rights of the debtor and contains a set of uniform conflict-of-laws rules with respect to the law applicable to the effectiveness of an assignment as against third parties and to priority disputes.

#### **2. The UNCITRAL draft legislative guide on secured transactions**

4. At its thirty-fourth session in 2001, the Commission decided to entrust a working group with the task of developing “an efficient legal regime for security rights ...”<sup>2</sup> Working Group VI proceeded with its work on the assumption that security interests in trade receivables will be covered in the legislative guide being prepared. Thus, the question arises of the relationship between the Convention and the legislative guide.

5. To the extent that the United Nations Assignment Convention addresses an issue, the recommendations contained in the legislative guide will be based on the principles codified in the Convention. To the extent that the United Nations Assignment Convention does not address an issue, the recommendations in the legislative guide will supplement the Convention. To the extent that the United Nations Assignment Convention addresses an issue only by way of conflict-of-laws

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<sup>1</sup> *Official Records of the General Assembly, Thirty-sixth Session, Supplement No. 17 (A/36/17)*, para. 100.

<sup>2</sup> *Ibid.*, *Fifty-sixth Session, Supplement No. 17 (A/56/17)*, para. 351.

rules, the recommendations in the legislative guide will support the application of the Convention in the sense that they will provide the substantive law to which the Convention refers. In particular, with respect to the law applicable to the steps required to make an assignment effective against third parties and the priority of that assignment, which the Convention refers to the law of the assignor's location (see art. 22), the recommendations will be designed to provide the applicable substantive law priority rules. Yet States adopting domestic legislation based on the recommendations of the legislative guide will still need to adopt the Convention since the Convention provides a higher level of uniformity.

## **B. UNIDROIT**

### **1. The UNIDROIT Convention on International Factoring**

6. The International Institute for the Unification of Private Law (UNIDROIT) completed in 1988 the UNIDROIT Convention on International Factoring (hereinafter referred to as “the UNIDROIT Factoring Convention”). While the United Nations Assignment Convention builds on the UNIDROIT Factoring Convention, the two conventions have a different scope of application and address different issues. However, the two conventions may apply to the same factoring contract and lead to different results. For this reason, article 38, paragraph 2, of the United Nations Assignment Convention specifically provides that, in the case of such a conflict, the United Nations Assignment Convention will prevail over the UNIDROIT Factoring Convention. To avoid leaving any doubt, article 38, paragraph 2, of the United Nations Assignment Convention, states also the obvious, namely that if the United Nations Assignment Convention does not apply to the rights and obligations of a debtor (because the debtor is not located in a State party to the United Nations Assignment Convention or the law governing the contract from which the assigned receivables arise is not the law of a State party to the United Nations Assignment Convention), it does not affect the application of the UNIDROIT Factoring Convention.

### **2. The Convention on International Interests in Mobile Equipment**

7. In 2001, UNIDROIT and the International Civil Aviation Organization (ICAO) completed the Convention on International Interests in Mobile Equipment (hereinafter “the Mobile Equipment Convention”) and the Protocol to the Convention on International Interests in Mobile Equipment on Matters specific to Aircraft (hereinafter referred to as “the Aircraft Protocol”). The Mobile Equipment Convention and the Aircraft Protocol may apply to the assignment of associated rights, including receivables secured by or associated with the equipment covered by the Mobile Equipment Convention and its Protocols (see arts. 1 (c) and 31). Thus, the United Nations Assignment Convention and the Mobile Equipment Convention and its Protocols may apply to the same transaction and lead to different results. For this reason, article 38, paragraph 1, of the United Nations Assignment Convention provides that it “does not prevail over any international agreement that has already been entered or may be entered into and that specifically governs a transaction otherwise governed by this Convention”. For the same reason, article 45 bis of the Mobile Equipment Convention provides that that Convention shall prevail over the United Nations Assignment Convention “as it relates to the assignment of

receivables which are associated rights related to international interests in aircraft objects, railway rolling stock and space assets".<sup>3</sup>

8. The relationship between the Mobile Equipment Convention and the Aircraft Protocol on the one hand and domestic law enacted on the basis of the recommendations of the UNCITRAL draft legislative guide on secured transactions is the same as the relationship between those texts and any domestic secured transactions law. While the Convention and the Protocol do not exclude the creation of security rights under national law, the international interest they create will usually give the creditor stronger rights than a purely domestic interest.<sup>4</sup>

### **3. The UNIDROIT draft rules regarding securities held with an intermediary**

9. In 2001, UNIDROIT set up a Study Group for the preparation of harmonized substantive rules regarding securities held with an intermediary. At its fourth session, held in March 2004, the Study Group considered a draft convention. The text that will emerge from the work of UNIDROIT will not be in conflict with the United Nations Assignment Convention, since the United Nations Assignment Convention provides that the assignment of receivables arising from securities is excluded from its scope (see art. 4, para. 2 (e)). Similarly, this text should not create conflicts with the recommendations to be included in the legislative guide on secured transactions being prepared by UNCITRAL since security rights in securities are excluded from the scope of the guide. The treatment of proceeds other than securities remains to be discussed in the context of the UNIDROIT text. Similarly, the treatment of securities as proceeds (or as part of a security interest in all assets of a debtor) needs to be discussed in the context of the UNCITRAL legislative guide.

## **C. Hague Conference on Private International Law**

10. In 2002, the Hague Conference on Private International Law completed the Convention on the Law Applicable to Certain Rights in Respect of Securities Held with an Intermediary. There can be no conflict between this text and the United Nations Assignment Convention as the latter excludes from its scope the assignment of receivables arising from securities (see art. 4, para. 2 (e)). For the same reason, there can be no conflict between this text and the legislative guide currently being prepared by UNCITRAL (as to the issue of securities as proceeds or part of a security interest in all assets of a debtor, see para. 9 ad finem).

## **D. European Bank for Reconstruction and Development**

11. In 1994, the European Bank for Reconstruction and Development (EBRD) prepared a Model Law on Secured Transactions.<sup>5</sup> In 1997, EBRD prepared a set of

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<sup>3</sup> See at <http://www.unidroit.org>.

<sup>4</sup> See Convention on International Interests in Mobile Equipment and Protocol Thereto on Matters Specific To Aircraft Equipment, Official Commentary by Professor Sir Roy Goode CBE, QC, Rome, September 2002, para. 22.

<sup>5</sup> See <http://www.ebrd.com/country/sector/law/st/prin/main.htm>.

ten Core Principles for modern secured transactions legislation.<sup>6</sup> These principles form the basis for assessing a country's secured transactions law and for identifying the need for reform. Currently, EBRD is considering a set of guiding principles on security interests registries. EBRD also provides technical assistance to countries within its region for legal and institutional reform in the area of secured transactions. The future UNCITRAL legislative guide on secured transactions is expected to take into account and build on the EBRD Model Law, Principles and the guide on security interests registries.

## **E. Asian Development Bank**

12. In 2000, the Asian Development Bank (ADB) published a guide on Secured Transactions Law Reform in Asia.<sup>7</sup> In 2002, the ADB published a Guide to Movables Registries.<sup>8</sup> The future UNCITRAL legislative guide on secured transactions is expected to take into account and build on those publications.

## **F. Organization of American States**

13. In 2002, the Organization of American States prepared the Model Inter-American Law on Secured Transactions.<sup>9</sup> The future UNCITRAL legislative guide on secured transactions is expected to take into account and build on this model law.

## **G. World Bank**

14. The World Bank is currently preparing a document entitled "Principles and Guidelines for Effective Insolvency and Creditor Rights Systems". This document deals with insolvency and secured transactions issues. It is expected that this document, together with the UNCITRAL guide on insolvency law and the UNCITRAL guide on secured transactions, once completed, will form a unified standard for insolvency and creditor rights.

## **H. European Union**

### **1. The Convention on the Law Applicable to Contractual Obligations**

15. The Convention on the Law Applicable to Contractual Obligations, opened for signature in Rome on 19 June 1980 (hereinafter referred to as "the Rome Convention") deals also with the law applicable to assignments. Under article 12.1, the law applying to the contract between the assignor and the assignee under the Rome Convention governs the "mutual obligations of assignor and assignee under a voluntary assignment of a right against another person". This law is the law chosen by the parties and, in the absence of a choice, the law of the country with which the contract is most closely connected (i.e. in the case of an outright assignment, the

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<sup>6</sup> See <http://www.ebrd.com/country/sector/law/st/modellaw/modlaw0.htm>.

<sup>7</sup> See [http://www.adb.org/Documents/Others/Law\\_ADB/lpr\\_2000\\_2.asp?p=lawdevt](http://www.adb.org/Documents/Others/Law_ADB/lpr_2000_2.asp?p=lawdevt).

<sup>8</sup> See [http://www.adb.org/documents/reports/movables\\_registries/default.asp](http://www.adb.org/documents/reports/movables_registries/default.asp).

<sup>9</sup> See <http://www.oas.org/main/main.asp?sLang=E&sLink=http://www.oas.org/documents/eng/documents.asp>.

assignor's country, and, in the case of an assignment by way of security, the assignee's country (see arts. 3, 4.2 and 4.5 of the Rome Convention)).

16. Under article 12.2, the law governing the assigned right "shall determine its assignability, the relationship between the assignee and the debtor, the conditions under which the assignment can be invoked against the debtor and any question whether the debtor's obligations have been discharged". This law is the law governing the contract from which the assigned right arises (i.e. the contract between the assignor and the debtor), namely the law chosen by the assignor and the debtor or, in the absence of choice, the law of the country with which that contract is most closely connected (e.g. in the case of a sales contract, the law of the seller/assignor).

17. Articles 28 and 29 of the United Nations Assignment Convention are almost identical with article 12 of the Rome Convention. Articles 22 and 30 of the United Nations Assignment Convention deal with the law applicable to the steps necessary to make an assignment effective against third parties and to conflicts of priority among claimants with a competing interest in the assigned receivables. Those articles may differ from article 12 of the Rome Convention, to the extent the Rome Convention addresses third-party effects of assignments. This matter is not clear, as there is a divergence of opinion in literature and practice as to whether article 12 of the Rome Convention applies to third-party effects. According to the prevailing view, article 12 does not address such issues. According to the minority view, article 12 deals also with third-party effects of assignments. This view is split though as to which law should apply, the law governing the assignment contract (art. 12.1) or the law governing the contract from which the assigned right arises (art. 12.2).

18. Articles 28 to 30 of the United Nations Assignment Convention along with other autonomous conflict-of-laws rules contained in chapter V of the Convention are subject to an opt-out by States. So, States parties to the Rome Convention that wish to ratify or accede to the United Nations Assignment Convention may enter a declaration that they will not be bound by those articles. However, article 22 of the United Nations Assignment Convention is not subject to a declaration as it reflects one of the most fundamental principles of the Convention (i.e. that priority is subject to the law of the assignor's central administration or habitual residence).

19. If article 12 of the Rome Convention is viewed as addressing the issue of the law applicable to third-party effects and applies to a transaction covered by the United Nations Assignment Convention, a conflict would arise since the two conventions would refer priority issues to different laws. Article 38, paragraph 1, of the United Nations Assignment Convention addresses such conflicts between conventions by deferring to a convention "that specifically governs a transaction otherwise governed by this Convention". So, the Rome Convention should not prevail over the United Nations Assignment Convention to the extent it is considered as dealing with contractual obligations in general and not specifically with assignments. However, the Rome Convention (art. 21) contains a similar provision and this might raise some doubt as to which convention prevails in the case of conflict.



## 2. The European Commission Green Paper on the conversion of the Rome Convention into a Community instrument and its modernization

20. The European Commission (hereinafter referred to as “the EC”) is currently considering revising the Rome Convention by way of a regulation or directive. In order to obtain the views of European Union member States, industry and practice, the EC has published a “Green Paper on the conversion of the Rome Convention into a Community instrument and its modernization (COM(2002) 654 final) of 14 January 2003”, posted on the EC web site (hereinafter referred to as “the Green Paper”).<sup>10</sup>

21. Question 18 of the Green Paper reads as follows: “Do you believe that a future instrument should specify the law applicable to the conditions under which the assignment may be invoked against third parties? If so, what conflict rule do you recommend?”<sup>11</sup>

22. In the comments contained in the Green Paper under “possible solutions” (3.2.13.3, point iv), it is mentioned: “application of the law of the assignor’s residence: this is the solution best capable of satisfying the criterion of foreseeability for third parties. Thus was this solution adopted by the United Nations Convention on the assignment of claims in international trade [footnote 89].”<sup>12</sup>

23. Article 22 of the United Nations Assignment Convention adopted the law of the assignor’s location because it is the only approach that (with the appropriate location rule) is most likely to produce a single law, a law that is, in most cases, easily determinable by all parties and a law that is the law of the jurisdiction in which the main insolvency proceeding with regard to the assignor will most likely be opened (also under EC Regulation No. 1346/2000 of 29 May 2000 relating to insolvency proceedings). All those considerations were thought to be essential for the availability and the lower cost of credit, an objective that is unlikely to be achieved if there is no certainty as to the applicable law. In this connection, the risk of the insolvency of the assignor was one of the most important considerations taken into account by the Commission. In the typical receivables financing transaction which involves several receivables owed by several debtors, the main risk for the assignee is not that one of many debtors may not pay but rather that a creditor of the assignor and, in particular, the administrator in the insolvency of the assignor, may claim and obtain the entire pool of the receivables assigned.

24. Under the United Nations Assignment Convention, the assignor is located at its place of business. The assignor is a single person and its place of business should be easily ascertainable by all parties. Where the assignor has no place of business, reference is to be made to its habitual residence. Where the assignor has a place of business in more than one State, the assignor is deemed to be located at the place where its central administration is exercised (art. 5 (h) of the United Nations Assignment Convention). The place of central administration is a place easily determined in the vast majority of cases. An approach based on the place of business of the assignor with the closest connection to the relevant transaction (see art. 4 (2)

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<sup>10</sup> See [http://europa.eu.int/comm/justice\\_home/news/consulting\\_public/rome\\_i/news\\_summary\\_rome1\\_en.htm](http://europa.eu.int/comm/justice_home/news/consulting_public/rome_i/news_summary_rome1_en.htm).

<sup>11</sup> Ibid.

<sup>12</sup> Ibid.

of the Rome Convention) was considered by the Commission and rejected because it did not provide sufficient certainty (in the case of assignments of future receivables) or could produce more than one law applicable (in the case of bulk assignments) and thus could have a negative impact on the availability and cost of credit. An approach based on the place of registration was also rejected as, in some cases, there could be more than one place of registration.

25. Moreover, the Commission was conscious that the approach it adopted might not produce one single law if the assignor made an assignment, moved its central administration to another country and then made a second assignment of the same receivables to another assignee. A provision that would have addressed this problem was considered but it was decided that there was no need for a such provision since a move of central administration takes significant time and the concerned assignees could then take the necessary precautions; it was also noted that assignors would be unlikely to make such moves just for defrauding assignees by making a second assignment of the same receivables.

### **3. Conclusions**

26. The Commission may wish to recommend that every effort be made to avoid that a revised article 12 of the Rome Convention in a future Community instrument takes a different approach than article 22 of the United Nations Assignment Convention.

27. The rule of article 22 of the United Nations Assignment Convention is the rule most likely to increase the availability and reduce the costs of credit within the EU itself. If the EU adopts a rule different than article 22 of the United Nations Assignment Convention, which other countries have adopted or are about to adopt, whether through their own domestic legislation or by adopting the United Nations Assignment Convention, then the EU would be decreasing the availability of credit and increasing its costs not only within the EU but also for cross-border transactions involving EU trading partner countries whose laws have adopted or are otherwise consistent with article 22 of the United Nations Assignment Convention.

28. For example, if the European Union and its major trading partners have different rules with respect to the law governing third-party effects of assignments, in a priority conflict between a United States assignee and a German seller with a retention of title extending to the proceeds from the further sale of the goods, different laws would apply to the same priority conflict depending on whether the dispute is brought before a United States or a German court. This uncertainty could defeat certain receivables financing transactions or at least raise their cost.

29. Also, if the European Union adopted a different rule just for parties located in EU member States, one law would apply to priority conflicts between EU parties and another between EU and non-EU parties, a result that could raise enormous practical difficulties and costs.

30. The same result may be obtained even if the revised article 12 were to adopt, as article 22 of the United Nations Assignment Convention does, an approach based on the assignor's law. This could happen since, under article 4.2 of the Rome Convention, the closest connection test may produce a law other than the law of the assignor's habitual residence or central administration. For example, unless reference were made directly to the law of the assignor's habitual residence or

central administration (see para. 24), a conflict of priority between a French and a United States bank receiving an assignment by a French branch of a United States assignor, under revised article 12 of the Rome Convention, could be subject to French law (the law with the closest connection to the assignment), while under article 22, it would be subject to United States law (the law of the central administration of the United States corporation).

31. In this light, in its comments on the Green Paper, the German Government noted that it is worth examining whether any new European legislation on the law applicable to third-party effects of assignments should be aligned with the United Nations Assignment Convention.<sup>13</sup> Taking this matter further, in its comments the Max-Planck Institute for Foreign and Private International Law and the Hamburg Group for Private International Law recommended the adoption of an approach based on the assignor's habitual residence or, in the case of legal persons, the assignor's central administration.<sup>14</sup>

32. In its comments on the Green Paper, the International Chamber of Commerce responded that the "ICC would prefer to see this issue dealt with within the Bankruptcy Directive or the UNCITRAL Assignment Convention. ICC believes that the European Commission's best choice would be a mandate to collectively ratify the UNCITRAL Assignment Convention for all EU countries and drop the current article 12 from the Rome Convention, if revised".<sup>15</sup> Such a solution presents the advantage that it does not require a revision of articles 12 and 4.2 of the Rome Convention, resolves the substance of the matter in the most appropriate way and avoids delaying EU and other States from obtaining the benefits to be derived from ratification of the United Nations Assignment Convention.<sup>16</sup>

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<sup>13</sup> See [http://europa.eu.int/comm/justice\\_home/news/consulting\\_public/rome\\_i/doc/bundesrepublik\\_deutschland\\_de.pdf](http://europa.eu.int/comm/justice_home/news/consulting_public/rome_i/doc/bundesrepublik_deutschland_de.pdf).

<sup>14</sup> See *Rabels Zeitschrift*, 67 (2003) 1, 45 and 51 and [http://europa.eu.int/comm/justice\\_home/news/consulting\\_public/rome\\_i/doc/max\\_planck\\_institute\\_foreign\\_private\\_international\\_law\\_en.pdf](http://europa.eu.int/comm/justice_home/news/consulting_public/rome_i/doc/max_planck_institute_foreign_private_international_law_en.pdf).

<sup>15</sup> See [http://europa.eu.int/comm/justice\\_home/news/consulting\\_public/rome\\_i/doc/international\\_chamber\\_commerce\\_en.pdf](http://europa.eu.int/comm/justice_home/news/consulting_public/rome_i/doc/international_chamber_commerce_en.pdf).

<sup>16</sup> So far, Luxembourg, Madagascar and the United States of America have signed the Convention. See <http://www.uncitral.org> [Status of texts].

**B. Report on UNCITRAL Colloquium  
on International Commercial Fraud  
(A/CN.9/555) [Original: English]**

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## I. Introduction

1. At its thirty-fifth session in 2002, the United Nations Commission on International Trade Law (UNCITRAL) decided that the secretariat should prepare a study of fraudulent financial and trade practices in various areas of trade and finance for consideration at a future session of the Commission.<sup>1</sup> The Commission noted that many fraudulent practices were international in character, that they had a significant adverse economic impact on world trade, that they also had a negative effect on the legitimate instruments of world trade, and that their incidence was growing, in particular since the advent of the Internet, which offered new opportunities for fraud. The secretariat accordingly convened a meeting of experts on 2-4 December 2002 at Vienna, at the headquarters of the Commission's secretariat to discuss this issue and to assist in drafting a note on possible future work for the next session of the Commission (A/CN.9/540).

2. At its thirty-sixth session in 2003, the Commission had before it the note by the secretariat on possible future work relating to commercial fraud (A/CN.9/540). Strong support was expressed by the Commission for the recommendation made by the secretariat (A/CN.9/540, paras. 65-67) that an international colloquium be organized to address various aspects of the problem of commercial fraud from the point of view of private law and to permit an exchange of views from various interested parties, including those working in national Governments, intergovernmental organizations and private organizations with a particular interest and expertise in combating commercial fraud. The Colloquium would also provide an opportunity to promote an exchange of views with the criminal law and regulatory sectors that combat commercial fraud and to identify matters that could be coordinated or harmonized. Further, on being informed of the possibility that the Commission on Crime Prevention and Criminal Justice could, through the Centre for International Crime Prevention of the United Nations Office on Drugs and Crime (UNODC), conduct a study of aspects of commercial fraud in consultation with UNCITRAL, the Commission, noting that its resources were fully engaged in the formulation of private law rules and related activities, sought the assistance of the Commission on Crime Prevention and Criminal Justice in conducting such a study.

3. The Colloquium was organized with the co-sponsorship and assistance of the Institute of International Banking Law and Practice and George Mason University, and in cooperation with the International Institute for the Unification of Private Law (UNIDROIT), the Organization of American States and the Hague Conference on Private International Law (the Hague Conference) at Vienna from 14 to 16 April 2004.

4. The speakers and panellists at the Colloquium consisted of a selection of experts from each of the practice areas examined, representing as broad a spectrum of approaches to the problem of commercial fraud as possible. The approximately 120 participants from 30 countries included lawyers, accountants, bankers, academics, security experts, law enforcement officials, regulators, and experts in the recovery of funds, as well as representatives of Governments and international

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<sup>1</sup> *Official Records of the General Assembly, Fifty-seventh Session, Supplement No. 17 (A/57/17)*, paras. 279-290.

organizations such as the Hague Conference on Private International Law, the OPEC Fund, the Arab League, the International Monetary Fund, the World Bank, the International Chamber of Commerce and the North American Securities Administrators Association.

5. The present note provides a summary of the Colloquium proceedings and key issues and includes recommendations to the Commission for possible future work in this area.

## **II. Commercial fraud in specific areas of private law**

### **A. General remarks and work in other international organizations**

6. There was general agreement that commercial fraud represented a serious drain on international commerce and brought harm to banking and financial systems and markets. It was noted that commercial fraud particularly affected small and developing countries, and led to instability. Further, it was acknowledged that fraud was linked to organized crime and possible connections could be drawn to terrorist activities. It was suggested that the goal of the Colloquium was to explore areas worthy of further study, to consider the prevention aspects of commercial fraud, and to consider working with the Commission on Crime Prevention and Criminal Justice in the furtherance of any studies on commercial fraud that might be undertaken.

7. Work related to the prevention of commercial fraud in other international organizations was discussed. UNODC noted the significant criminal law dimensions of commercial fraud, as well as its own responsibility for criminal law and criminal justice issues, and outlined its achievements in the development of international law in this area. In particular, UNODC outlined its role as the secretariat for the negotiations that led to the United Nations Convention against Transnational Organized Crime and Protocols Thereto,<sup>2</sup> and to the United Nations Convention Against Corruption,<sup>3</sup> which was recently opened for signature. Key aspects of both of these global instruments were highlighted, including their universality, their highly participatory nature in aiming to achieve consensus and involve practitioners in the development of the instruments, their inherent equilibrium between the need for domestic measures and provisions for asset recovery. UNODC advised the Colloquium of the upcoming thirteenth session of the Commission on Crime Prevention and Criminal Justice to be held from 11 to 20 May 2004 in Vienna and of the United Nations Eleventh Congress on Crime Prevention and Criminal Justice to be held from 18 to 25 April 2005 in Bangkok. UNODC reported that the recommendations of the African Regional Preparatory Meeting held in March 2004 in Addis Ababa and the Asia and Pacific Regional Preparatory Meeting held in March 2004 in Bangkok, in preparation for the Eleventh Congress, specifically recognized that new forms of economic and financial crimes had emerged as

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<sup>2</sup> New York, 15 November 2000, the Protocol to Prevent, Suppress and Punish Trafficking in Persons, Especially Women and Children, the Protocol against the Smuggling of Migrants by Land, Sea and Air, and the Protocol against the Illicit Manufacturing of and Trafficking in Firearms, Their Parts and Components and Ammunition.

<sup>3</sup> Adopted and opened for signature by United Nations General Assembly resolution 58/4 of 31 October 2003.

significant threats to the national economies of States, and recommended that the Eleventh Congress explore the possibility of negotiating international legal instruments in those fields. UNODC noted that the preparatory meetings had indicated that it was increasingly apparent that more knowledge was required with respect to the incidence, effects and consequences of commercial fraud. UNODC expressed its support for and keen interest in the Colloquium, noting that its conclusions and recommendations would assist UNODC in the development of its own future programme of work.

8. A presentation on related work at the Hague Conference was also presented, focusing on the 1961 Apostille Convention,<sup>4</sup> which recent studies have shown to be widely used in the avoidance of the forgery of signatures on public documents. The Hague Conference on the use of apostilles is preparing a handbook, which should be available by the end of 2004.

## **B. Banking and trade fraud**

9. Using the context of recent examples of commercial fraud perpetrated in banking and trade, participants in the Colloquium discussed a number of major issues common to such frauds, and, it was noted, to many frauds in general. This opening discussion set out a number of key issues that arose throughout the course of the Colloquium.

10. Two key aspects that emerged were how the volatility of the commodity in issue could exacerbate the fraud, and the importance of the financial institution's gaining a complete understanding of all aspects of the transaction that it was financing. Other problems were said to be the organization and structure of the defrauded institution or organization itself, and that internal rivalries and commission-based compensation or other incentive schemes could worsen the potential for an institution or organization to be defrauded. Other areas of vulnerability were said to emerge when a financial institution was eager to become involved in a particular type of business or transaction, and was perhaps less diligent as a result, and the relatively short institutional memories that most organizations have that can result in their being victimized by similar frauds after a cycle of approximately 10 to 12 years. A particularly complicating factor in detecting frauds was said to be cases in which the buyer and the seller of a commodity colluded in carrying out the fraud. One hallmark in banking and trade frauds was said to be the initial use of legitimate financial instruments and transport documents, and the gradual introduction of worthless and meaningless documents in subsequent transactions. Important factors in combating such frauds were suggested to be the courage of a board member or a banker to admit a lack of understanding of a complex transaction, and the implementation by the institution of appropriate due diligence programmes.

11. The difficulty in prosecuting economic crimes and in taking civil actions on fraud was discussed. While some frustration was expressed with the punishment meted out in successfully prosecuted cases, there was agreement that there was an increasing realization that the effects of economic crime can be very damaging.

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<sup>4</sup> Hague Convention of 5 October 1961 Abolishing the Requirement of Legalisation for Foreign Public Documents.

Concern was expressed at the lack of successful prosecutions in complicated fraud cases, which require a high degree of expertise on behalf of all involved, including prosecutors, judges and jurors. The suggestion was also made that successful prosecution of fraud was not necessarily a sufficient deterrent, and that perhaps efforts should be made to examine fraud prevention from the perspective of why people commit fraud. Other aspects discussed included the extent of the liability of parent companies and their officers for fraudulent actions by subsidiaries, whether they may be liable to make restitution, and whether a reporting obligation should be imposed.

12. Another topic explored was the common situation of proceeding in fraud cases on dual track criminal and private investigation, enforcement and recovery, and the problems this can create. For example, criminal enforcement agencies are often unable to provide information that would assist in private investigation and recovery. Recovery of assets is the primary concern of private entities, but is not the main aspect of criminal sanctions. In addition, it was generally agreed that increased cooperation between the two sides would often help companies with respect to prevention and investigation, but companies are often wary of appearing susceptible to fraud. It was also suggested that, given the scarcity of resources, sometimes law enforcement agencies prefer that commercial entities perform their own investigations. However, for examples of the public and private sectors working together to combat fraud, see paragraphs 17 and 25 to 28 below, with respect to investigation and prevention.

13. One problem raised was the lack of hard data on the extent and type of fraud that is committed. Other recurrent themes in the Colloquium were the importance of dispelling the image of commercial fraud as a victimless crime, and the general difficulty of having to prove fraudulent intent. This difficulty is compounded when, for example, documents are presented that were forged by a third party.

### **C. Investigation**

14. The session on the investigation of fraud and the issues faced during an investigation noted the importance for most victims of fraud of finding evidence that would lead to financial recovery. Of particular importance in this regard was the use of computer forensics, which can allow investigators to take immediate action to preserve assets and to uncover evidence of further fraud that often becomes apparent after the initial discovery. Using such techniques, investigators are able to discover, preserve and analyse digital data including activity of deception, copies of documents, profiles of the fraudster, and patterns of activity. It was noted that a traditional audit would probably not detect management fraud, which was the source of most material frauds.

15. A case study concerning a case of employee fraud was given to demonstrate some of the investigative techniques that can be used to track and uncover frauds. The case emphasized the importance of cooperation between private fraud investigators and law enforcement personnel, especially early in the investigation. It was suggested that fraud on the part of employees and other insiders of existing companies, whether among themselves or in cooperation with persons outside the



company, accounted for considerable losses and that corporations should be encouraged to screen and monitor their employees more effectively.

16. It was noted that recent major corporate scandals have threatened investor and corporate confidence and have made it clear that the commercial community should be prepared for large-scale fraud. Some countries have responded to these scandals with specific legislation, increased criminal enforcement and increased recognition of financial crime as a major problem.

17. The participants in the Colloquium heard a presentation on a system developed in one country to respond to these types of corporate scandals, where civil recovery was occurring, but no criminal sanctions were being assessed. Rather than simply to issue guidelines to industry, it was decided that increased criminal enforcement of corporate crime was the key to prevention and enforcement of commercial fraud. The government set up integrated market enforcement teams in four major financial centres of that country in order to target high-level corporate fraud that affected publicly traded companies. The teams, whose job is to anticipate and prevent certain types of fraud before they cause bankruptcies, are comprised of representatives from local and international law enforcement, securities commissions, and private businesses. These teams involve local prosecutors and the judiciary and are meant to meet the threat of fraud quickly, to deal rapidly with enforcement, then to move on to address the next potential problem.

18. There was general agreement that proactive techniques by law enforcement agencies were very important to the prevention and detection of fraud, particularly with respect to the public impact of such operations. It was also noted that speed was very important in the investigation and prosecution of frauds, and that this was likely to mean that investigators would focus on certain aspects of the fraud, rather than on every detail of it.

19. A particular fraud that investigators have encountered frequently concerns prime bank instruments or high-yield instruments, through which fraudsters have been able to steal large sums of money. The fraud is typified by complex transactions that often have an international component, unrealistic rates of return and other enticing rewards for investors and demand of investors a high level of secrecy. It was noted that the national law enforcement agencies have successfully organized major investigations of these types of fraud, and that coordination with law enforcement agencies from around the world often plays a key role in the investigation of these frauds.

#### **D. Cyber fraud**

20. The session of the Colloquium addressing cyber fraud advised participants of a project supported by a national government to study the protection of critical infrastructures within the country and internationally. The project aims to enhance the security of cyber networks and economic processes supporting the country's critical infrastructures, and as a consequence, examines the vulnerability of computer systems to fraudsters and hackers. The intersection of cyber security and cyber fraud was explained, in that government, industry and individuals form part of the network and must each play a role in preventing fraud and hacking activities.

21. It was noted that computer systems were particularly vulnerable to fraudsters because of increased access to the Internet, which could enable them to attack government, corporate, and individual computer systems. It was suggested that avoidance of such attacks could best be achieved by increasing the awareness of Internet users regarding how their transactions might be susceptible to fraud.

22. It was noted that cyber security was particularly important to businesses, which have unique responsibilities to keep confidential their customers' personal information. To that end, technology experts have developed new methods to protect information and new methods of using computer forensics.

23. The participants heard about a new security technique being developed by technology experts, mainly for military and intelligence purposes. However, the technology could be used to allow a business's computer system to persuade a potential fraudster that it is succeeding in attacking the business, while allowing the business to gather information about the fraudster and avoid the threat.

24. In addition, it was acknowledged again that the Internet played an important role in the growth of commercial fraud because it enabled fraudsters to increase their reach and profits. As such, Internet security plays an important role in the prevention of fraud.

## **E. Prevention**

25. The Colloquium session on the prevention of fraud introduced the participants to a novel approach to the prevention of commercial fraud at a regional level. A group of law enforcement officials and representatives from the public and private sectors in northern England have organized a forum to fight fraud and financial crime in the region. The participants heard that the North East Fraud Forum (NEFF) links the public and private sectors with government and international agencies and meets at various points throughout the year to discuss prevention issues. NEFF also organizes a series of workshops and classes to educate the public and private sectors about commercial fraud. NEFF agreed that fraud is an international problem, but emphasized its success in addressing commercial fraud on a local level.

26. NEFF's goal since its inception in 2003 has been to provide realistic solutions to fight commercial fraud, and through a series of master-classes and workshops, to provide education for professionals in the area. The long-term goals of NEFF include studying and measuring fraud, reducing it in the region and assisting other regions locally and throughout the world in the adoption of its public-private sector model. It was suggested that such forums could eventually be united under one international forum, so that each region could address its own problems of fraud, while working with other regions to reduce the global effects of fraud.

27. An update of the estimated effects that commercial fraud has had on the global economy was provided by the International Chamber of Commerce (ICC). Using Austria as an example, it was estimated that the losses from fraud amounted to approximately 3-4 billion euros, or 5-10 per cent of Austria's gross domestic product. In any case, it was suggested that estimates of losses are likely low because only 3-5 per cent of cases of fraud are actually reported. It was also noted that the ICC, particularly in Austria, has closely interwoven connections with the public and

private sectors that it uses to prevent commercial fraud. It was further suggested that prevention of commercial fraud could also benefit from a deeper examination of the systemic causes that provide opportunities and incentives for fraud.

28. Interest in the NEFF model was expressed by a number of participants. One concern that was expressed was the extent to which information and intelligence could be exchanged between the public and the private sectors. It was noted that local legislation could be helpful in this regard, as was the conclusion of memoranda of understanding between the various organizations involved in NEFF.

29. Questions were also raised during this session with respect to whether and how commercial fraud could be defined. While it was noted that under common law, theories of fraud under tort and contract law could allow for enforcement and recovery without using the criminal law apparatus, commercial fraud tended to have both a criminal dimension and a civil dimension, and it was suggested that both were necessary in order to enable the private sector to protect, defend or allocate its rights in light of serious departures from normal commercial behaviour. Further discussion of the difficulty of defining the term is in paragraph 64 below.

## **F. Transport**

30. The Colloquium session on transport fraud began with a discussion of maritime fraud. It was noted that maritime transport provides a fertile breeding ground for fraudsters because of the complexity of the transactions and because of the use of negotiable documents. Four of the essential commercial requirements of negotiable documents are susceptible to fraud, particularly in an uncertain legal environment: the reliability of the shipper and the carrier; the reliability of the contents of the document (particularly the description of goods); the exclusivity of the right of the holder of the document; and the availability of the document when it is needed at the place of destination of the goods.

31. The participants heard how a draft instrument on the carriage of goods [wholly or partly] [by sea] currently being discussed in UNCITRAL's Working Group III (Transport) specifically addresses each of these points of weakness (the draft instrument).

32. Provisions in the current version of the draft instrument require that the carrier be properly identified and traceably located, failing which, the owner of the vessel would be identified as the carrier, and joint liability of the actual and contractual carriers will mean that recourse may be had to the assets of the actual carrier. The carrier's obligations will be clarified, with fault-based liability and a reversal of the burden of proof such that recourse actions against the carrier will be more successful and more predictable for sellers and banks. Shippers, too, will be better identified and categorized and their obligations and liabilities clarified, with the expectation that the opportunities for fraudulent misrepresentation will thereby be reduced.

33. The draft instrument also attempts a detailed regulation of the contents of the documentation involved to resolve current uncertainties to as great an extent as possible. It also addresses the transferability of the rights incorporated in a negotiable instrument and the exercise of those rights with their attendant liabilities.

Other innovations in the draft instrument concern the inclusion of provisions on the right of control, including the right to demand delivery of the goods before their arrival at the place of destination and the right to replace the consignee with another person, both important rights to safeguard the interests of an unpaid seller or of a bank, and which may apply even in cases where no document at all is issued. Further, the consignee is under a duty to collect the goods if he exercises any rights under the contract of carriage and the bill of lading holder has an exclusive right to take delivery of the goods upon their arrival at the place of destination. In addition, the draft instrument recognizes that the innocent holder of a bill of lading deserves protection, such that the holder loses its rights to take delivery only if it should reasonably have known that the goods might already have been delivered. However, there may still be rights outside of the right to take delivery connected with the document if it is a result of a string of contractual or other arrangements made before delivery. Finally, the draft instrument also makes provision for electronic transport documents, including negotiable documents. Through these and other measures, the draft instrument attempts to clarify the uncertain legal environment that can allow transport fraud to thrive.

34. In addition to the complex documentary aspects of maritime trade, factors that further complicate transport fraud in general are the international nature of the transactions, the fact that the transport is only one aspect of a particular contract of sale and that there are often a number of buyers and sellers in the chain.

35. It was reported that the air transport industry alone saw losses of over US\$ 300 million detected in 2002, but that the total estimated fraud in that period was US\$ 1.5 billion. Airline fraud has been defined as any action that deprives the carrier of the revenue to which it is entitled that is undertaken without the carrier's knowledge or consent. These losses are typically a result of ticketing irregularities and other fraud, frequent flyer account fraud, credit card fraud and ticket fraud. The air transport industry again demonstrated the difficulty in addressing these frauds because they typically cross international borders and that the Internet and use of electronic distribution methods have compounded the problem. The air transport industry expressed both its belief that only cooperation can protect businesses from fraud and its eagerness to work with other entities in combating fraud.

## **G. Insurance**

36. During the session on insurance fraud, participants heard that insurance fraud may include false claims or inflated insurance claims, or genuine losses where a lack of evidence is exploited. More complex insurance frauds could include money-laundering through legitimate insurance markets by channelling insurance premiums through a chain of valid insurance and reinsurance companies, ultimately into the fraudster's reinsurance company. A complicating factor in insurance fraud is that, because of the definitions typically used in insurance policies, insurance companies must prove fraud beyond a reasonable doubt, without having the powers available to law enforcement. In addition, the civil and criminal interface of fraud is particularly prevalent in insurance fraud and, as outlined above in paragraph 12, information-sharing and cooperation between the two may be limited, and there are often competing priorities between criminal punishment and financial restitution. Other complicating issues in insurance fraud are data protection and human rights issues,

as well as the need to maintain good customer relations while avoiding being victimized by fraud.

37. Another aspect raised was the issue of how companies insure themselves against losses due to fraud and economic crimes. It was noted that this issue is a function of the risk-management decisions that each company makes and, depending on the potential economic costs of a commercial fraud, there may even be a decision not to insure that risk at all.

38. When an insurance company has been victimized by a fraud, companies have often found it difficult to prove the fraud in court to recover their losses. Again, it was noted that the companies face difficulties in educating juries regarding the operation of a normal insurance policy, as well as which aspects of a specific transaction were fraudulent.

39. It was suggested that insurance frauds might involve other areas of law enforcement or regulation, which may assist in investigating the fraud. For example, the resale of life insurance policies for the terminally ill, which involves middlemen or investors, can result in involvement by securities regulators and investigators. This was cited as another example where cooperation between the public and private sectors could lead to faster and more effective action against fraudsters.

## H. Recovery

40. Participants in the Colloquium also discussed the important issue of asset recovery once a fraud has been detected. A number of practices were suggested that would help businesses to recover their assets quickly before they are completely dissipated and lost. These practices include: fast action, taking risks in investigation, working with proven experts, using technology, cultivating and using networks of professionals and using civil and criminal facets of the law simultaneously.

41. It was also suggested that businesses consider traditional as well as non-traditional means of recovery. For example, it was suggested that a careful selection of which action to bring may help a business to recover its assets more efficiently, and a particular type of action may be more successful in recovering assets in a particular country. Because there may be specific procedures established, it was suggested that maintaining relationships with lawyers in multiple jurisdictions may help assist in recovery. In addition, reliance on private tracing and enforcement may be necessary, especially in jurisdictions where cooperation with the judiciary is either inappropriate or inefficient. Further leverage in obtaining information and recovering assets may be obtained by suing insurance companies and individuals or entities that have orchestrated the structure set up to diffuse the assets. Again, the importance of computer forensics was noted in the tracing of assets and the discovery of frauds.

42. It was noted that, given that assets have often been transferred to other jurisdictions, a major problem in recovering them has been a lack of reciprocity between different jurisdictions. While mutual legal assistance treaties have been useful in some circumstances, it was suggested that more widespread legal cooperation should be encouraged to help businesses recover assets more efficiently, and the UNCITRAL Model Law on Cross-Border Insolvency was cited for its

inclusion of provisions on judicial cooperation. Again, it was noted that greater cooperation between the public and private sectors would also be an enormous help in the recovery of assets. A further complicating factor in the recovery of assets has been the issue of bank secrecy as an excuse for non-cooperation. It was also suggested that tolerance of low-grade corruption and of judicial corruption must stop in order to put an end to fraud. It was also noted that the United Nations Conventions against Transnational Organized Crime and against Corruption (see para. 7 above) include provisions for the recovery of assets.

## **I. Money-laundering**

43. In the session on money-laundering, it was noted that, originally, the money-laundering rules that had been established internationally were aimed at recovering the profits of illegal drug trafficking. However, international organizations recently recognized that money-laundering was a problem on its own terms and should be addressed separately from other laws.

44. The primary set of rules that has been established for countries to follow concerning money-laundering is the Financial Action Task Force's Forty Recommendations on Money Laundering, which establish a comprehensive framework for combating money-laundering and terrorist financing. The Recommendations provide a set of standards and procedures for member countries to follow in establishing their own rules for combating money-laundering and terrorist financing, and for implementing those measures. The recommendations broaden the definition of illegal acts, the proceeds of which should be the subject of anti-money-laundering statutes. In addition, they establish a framework for international cooperation and mutual assistance.

45. In addition, the United Nations Convention against Transnational Organized Crime has recently defined money-laundering to include a broader range of illegal acts to include all serious offences instead of merely drug charges. It also extends its provisions to cover laundering of property as well as cash.

46. It was emphasized that it was important for banks to monitor their customers' accounts and to know their customers. Typically, a bank's internal controls might monitor specific transactions, but recently technology has been improved to monitor suspicious transactions in general. The company must also monitor its accounts and transactions, looking for those that are suspicious or susceptible to fraud. In addition, since due diligence can be a defence to certain actions, it is important that the bank or business be able to demonstrate that it had used proper procedures and had established the proper mechanisms to protect itself.

47. The intersection of terrorism, money-laundering and fraud was noted. Further, participants were advised that the International Monetary Fund had recently made money-laundering part of its permanent body of work, and that it had devised a methodology to assess whether a specific country had adopted sufficient procedures to protect against money-laundering.

## J. Insolvency

48. During the session on insolvency, it was noted that the insertion of fraud into an insolvency case makes it much more complicated and that there were two main areas where fraud and insolvency overlapped. The first area was where fraud resulted in insolvency and the second was where the legal tools available in insolvency could assist in dealing with commercial fraud and tracing funds, for example, powers of execution, the ability of the liquidator to set aside certain transactions and the like. It was noted, however, that the purpose of insolvency rules was to allow creditors to make informed decisions regarding how they should proceed and that, generally, it would not be practical for specific insolvency rules to be created to deal with fraud.

49. It was suggested that in some jurisdictions the legal framework to tackle fraud in insolvency exists, but improvements are needed in implementation, in controlling the misuse of legal tools, and in providing for specialized and vigilant insolvency professionals, including judges. Again, participants pointed to the importance of international comity and coordination and cooperation between the public and private sectors in combating insolvency-related fraud. It was noted that a valuable and practical tool in this area is the UNCITRAL Model Law on Cross-Border Insolvency,<sup>5</sup> which both promotes and makes specific provision for recognition, assistance and cooperation between jurisdictions where an insolvent entity has assets or debts in more than one State. It was also observed that the effectiveness of the Model Law would be greatly enhanced by its widespread adoption.

## K. Prosecution

50. In the session on the prosecution of fraud, it was noted again that a major problem facing investigators and prosecutors is the fact that frauds are often hard to prove, both because of the limited access to evidence and because of the sophistication of the schemes involved. Further, cooperation with foreign governments and institutions would often provide the level of access that a prosecutor needs to obtain evidence and information regarding the transaction, but such cooperation is often hard to establish.

51. With respect to high-yield investment frauds, it was noted that several factors are typical to these transactions and can be established by expert testimony or through comparison of the fraud with legitimate transactions. For example, certain phrases such as “clean and clear funds of non-criminal origin” or “high-yield investment” or “medium-term notes” or “top ten world banks” appear in many fraudulent transactions. The schemes will also often use the reputation of legitimate international organizations or instruments of commerce, or impressive buildings or foreign addresses, to establish a degree of credibility in order to persuade the victim of the genuine nature of the scheme.

52. It was noted that a number of organizations had adopted web sites in their attempts to educate individuals regarding the fraudulent nature of these schemes or the improper use of the organization’s name or legitimate products. These include

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<sup>5</sup> *Official Records of the General Assembly, Fifty-second Session, Supplement No. 17 (A/52/17), annex I.*

the World Bank, the International Chamber of Commerce and the United States Department of the Treasury Bureau of the Public Debt.

53. Finally, despite the unwillingness of victims to admit that they have been victimized, investigators and prosecutors advised that they have had success in persuading victims to admit their plight by having local law enforcement serve the victim with a document asserting that they have taken part in a fraudulent scheme and that any further activity of this type will result in charges being laid against the victim.

## **L. Procurement**

54. During the session on procurement fraud it was suggested that procurement frauds are generally of two types: inward fraud where the procuring company is being victimized by a fraudster and outward fraud where a company is complicit in the fraud and allows itself to be a part of the scheme. It was noted that while there is generally good cooperation by the public and private sectors in preventing and discovering inward fraud, there is little assistance or incentive in the prevention and investigation of outward fraud. Further, it was suggested that many multinational corporations actually assist in exporting fraud through engaging in bribery, corruption and price-gouging. It has been estimated that 20 per cent of procurement fraud is known to the public, 20 per cent is known to only a few individuals, and 40 per cent of the fraud is known by no one.

55. Some of the typical types of fraud involved in procurement include services not being performed, terms of the contract being ignored, the involvement of front companies to steal money, non-existent and over-priced goods, failure to enforce contract conditions and blatant theft. Various strategies were discussed to prevent and identify fraud and fraudsters, including the importance of the segregation of various duties within a business to separate individuals. Another aspect of procurement fraud that was examined was the “slippery slope” argument, where what starts out as a few perquisites for customers gradually descends into corruption and bribery.

56. It was also noted that the main thrust of UNCITRAL’s fairly extensive body of work in the procurement area has been to ensure the transparency and fairness of the procurement process, thereby, at least implicitly, attempting to reduce or eliminate fraud. In addition, it was suggested that consideration should be given to the issue of fraud in relation to the privatization of public assets.

## **M. Role of professionals**

57. During the discussion on the role of professionals with respect to commercial fraud, the participants in the Colloquium were informed of a particular instance where a self-regulating professional body had taken its own measures to combat fraud and dishonesty in the profession. The Law Society of England and Wales created a Fraud Intelligence Unit to build links with financial institutions and law enforcement agencies, to generate and collate intelligence, to investigate and enforce, and to establish a forensic investigations unit and develop expertise in using statutory powers proactively. A network of public and private sector groups



has been established for whistle-blowing, liaison and mutual assistance purposes. Specific areas of concern to the Law Society are mortgage fraud, advance fee fraud, legal aid fraud, high-yield investment fraud and money-laundering activities.

58. One aspect discussed by participants was that the involvement of professionals such as lawyers and accountants in commercial frauds contributed considerably to their scope and success, and that in many locations the mechanisms of regulation and discipline have not been adapted to deal with professionals who have entered into systematic commercial frauds. It was also noted that the participation of professionals in frauds is particularly problematic, since it serves to legitimize the fraud and thus to perpetuate it. It was suggested that the formation of model guidelines might be encouraged to assist self-regulating professional bodies in such situations.

## **N. Securities**

59. During the session on securities fraud it was suggested that, while the popular perception was that insider trading was the largest problem with respect to securities matters, one of the most serious and damaging problems in the area of securities was actually fraudulent financial reporting. It was estimated that in the United States of America alone, between 1997 and 2002, the Securities and Exchange Commission instituted over 200 enforcement matters against more than 150 entities and over 700 individuals, resulting in over 500 disciplinary actions for financial reporting and disclosure violations. The participants heard that the areas of financial reporting most susceptible to fraud are improper revenue recognition, improper expense recognition, and improper accounting in connection with business combinations, while there exists a host of other minor violations.

60. Boards of directors are often implicated in such activity through failing in their fiduciary duties, high risk accounting, inappropriate conflicts of interest, extensive undisclosed off-the-books activity, excessive compensation and lack of independence. Further, the primary categories of auditor violations are outright fraud, violation of disclosure requirements and improper professional conduct. Again, it was noted that the involvement of professionals, such as accountants, grants credibility to the fraud and enables it to continue, while self-regulation of professions may not be effective. Enforcement procedures in such cases are often administrative proceedings based on the rules of the securities regulator and often involve civil and criminal prosecution.

61. The Colloquium also heard that a large number of fraud prosecutions have been conducted by securities regulators and, although there is some international cooperation between those regulators, a higher level of such cooperation is required. Nonetheless, it was suggested that increased sharing of information, for example, with respect to databases that have been developed, would greatly assist in the enforcement and prevention of commercial fraud.

## **III. Conclusions and suggestions for future work**

62. There was broad consensus that the Commission had been well advised to convoke a Colloquium on international commercial fraud and that it had contributed

to an important first step in recognizing the existence of the problem. It was agreed that the Colloquium had dispelled any doubts that remained as to the widespread existence of commercial fraud and its significant impact on all countries, regions, economies and industries, regardless of the stage of economic development or system of government. Each of the substantive areas addressed at the Colloquium had been seriously affected by commercial fraud.

63. It was also agreed that education and training play a significant part in fraud prevention and could help address the problems resulting from under-reporting. Not only are the resources of the criminal justice system often focused on other law-enforcement priorities, they are ill-suited to undertake efforts of education without active cooperation from the private sector. It was also agreed that prevention, which is perhaps the most potent tool against commercial fraud, is primarily within the purview of commercial law and self-regulation by the commercial community, and is manifested through standards such as those affecting corporate governance, standards of professional conduct and audits. It was suggested that it would be particularly useful to identify common warning signs and indications of commercial fraud. Moreover, commercial fraud raises questions of the allocation of risks and losses in addition to the recovery of the proceeds of fraud, matters that are within the sphere of commercial law. In many cases, these matters involve cross-border issues. It was also agreed that the impact of commercial fraud could be disproportionately harmful to developing countries and undermine the positive effects of international efforts to improve their economic situation. Participants were hopeful that the Commission would continue to address the problem of commercial fraud in a manner consistent with its mandate and resources.

64. Although in the preparatory work leading to the Colloquium some progress was made towards fashioning a description of commercial fraud (see A/CN.9/540, paras. 12-26), it was generally thought that additional work would be necessary to formulate a definition, characterization or precise description. For example, while money-laundering, as such, would probably not fall within the definition of commercial fraud, and corruption may or may not do so, depending on how "corruption" is defined, both topics are of considerable concern in any work on commercial fraud. Money-laundering also often follows from a successful commercial fraud and may even be a tool to assist in perpetrating one. Corruption can facilitate commercial fraud whether or not it is technically a form of commercial fraud.

65. It was suggested that serious consideration should be given to developing a means of gathering and publicizing statistics and information about commercial fraud. While it was recognized that there might be some privacy concerns regarding information about individuals, it was also agreed that there are estimates and other figures, publicly available in a variety of different forms, such as trade association figures, that are typically only known within relatively small industry groups. It was suggested that gathering such figures would itself add considerably to the understanding of the nature and extent of commercial fraud and in developing an analysis of the relative costs and benefits of fraud prevention and relevant law enforcement. Moreover, it was suggested that public information about types of fraud, typical patterns and links to other sources of information would be of considerable value in the fight against commercial fraud.

66. Participants emphasized that education and training were of particular importance and value in fraud prevention. It was also agreed that local cooperative efforts between police and the private sector as demonstrated in NEFF's model seemed particularly effective and should be encouraged in other regions (see paras. 25-28 above).

67. It was generally agreed that the United Nations Convention against Transnational Organized Crime and the United Nations Convention against Corruption were significant achievements in the development of international law related to increased awareness and prevention of commercial fraud and related activities, as well as international cooperation thereon and asset recovery. The Commission may wish to endorse these two important conventions and encourage States to sign and ratify them.

68. Further, in light of the presentation made by UNODC (see above, para. 7), and in light of the paucity of firm data on commercial fraud, the Commission may wish to suggest to the Commission on Crime Prevention and Criminal Justice that it consider conducting a study on commercial fraud through the United Nations Office on Drugs and Crime, in consultation with UNCITRAL, in preparation for the Eleventh United Nations Congress on Crime Prevention and Criminal Justice. The aims of such a study would be to explore and increase knowledge of the criminal law and criminal justice perspectives of commercial fraud, their implications for commercial law aspects of fraud and vice versa, and to address the requisite international cooperation to deal with this problem.

69. Given the technological developments and experience in the application of the UNCITRAL Model Law on Procurement of Goods, Construction and Services,<sup>6</sup> it has been proposed that procurement law should be included in the programme of work of the Commission, including a review by Working Group I (Procurement) of certain provisions of the Model Law and its accompanying Guide to Enactment (A/CN.9/403). It is suggested that as part of its work during its next session, the Working Group could specifically consider the issue of commercial fraud in terms of issues of integrity management and corruption avoidance. In particular, it is proposed that the Working Group could benefit from presentations on these topics from international lending institutions (such as the World Bank) and from the International Federation of Consulting Engineers, with whom UNCITRAL has worked successfully in the past.

70. In similar fashion, Working Group III (Transport) could benefit from a presentation similar to that given during the Colloquium, which outlined the potential for commercial fraud in the area of maritime trade and bills of lading. The discussion could be of particular interest to the Working Group given the efforts of the draft instrument on the carriage of goods [wholly or partly] [by sea] (A/CN.9/WG.III/WP.32) to close off various avenues of opportunity that have proven fertile ground for the perpetration of commercial fraud.

71. It was also suggested that the risks of commercial fraud arising in electronic commerce is a topic that the Commission may wish to address in due course. For example, an analysis of existing legislative and other electronic commerce texts

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<sup>6</sup> *Official Records of the General Assembly, Forty-ninth Session, Supplement No. 17* and corrigendum (A/49/17 and Corr.1), annex I.

(such as model contracts and model protocols) may be undertaken, so as to consider whether they are sufficiently robust to assist in the prevention of fraud. It may also be possible to consider a regulatory regime that could govern conduct in situations where, for example, a fraudster misuses a web site to defraud its victims and law enforcement agencies seek to have an Internet service provider shut down that web site. The experience of such agencies in analogous fraud situations, in which the interaction between criminal law enforcement and commercial contractual rights, duties and liabilities have been addressed, may also be instructive in this regard.

## **XI. OTHER BUSINESS**

### **Note by the Secretariat on partnerships between the United Nations and non-State actors, in particular the private sector: recent developments across the United Nations and possible implications for the Commission's work**

**(A/CN.9/564) [Original: English]**

1. The purpose of this note is to draw the Commission's attention to the Secretary-General's report to the fifty-eighth session (2003) of the General Assembly entitled "Enhanced cooperation between the United Nations and all relevant partners, in particular the private sector" (A/58/227)<sup>1</sup> and the General Assembly action on that report.
2. In his report (A/58/227), the Secretary-General reviewed recent developments with respect to partnerships between the United Nations and non-State actors;<sup>2</sup> concluded that partnerships, in innovative and diverse forms, became an integral part of many United Nations organizations, and that they had the potential to complement the Organization's efforts to achieve its objectives, while at the same time contributing to its renewal by introducing new methods of work;<sup>3</sup> formulated proposals on how best to utilize the potential benefit of partnerships; and stressed the need for Governments and United Nations organizations to continue encouraging and supporting promising approaches and initiatives.<sup>4</sup> The Secretary-General envisages establishing a new Partnership Office that would ensure a more coherent and systematic approach across the United Nations system to building partnerships between the United Nations and non-State actors.

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<sup>1</sup> The report was submitted under agenda item entitled "Towards global partnerships" which was on the General Assembly agenda since its fifty-fifth session, in 2000. For the resolutions adopted under this agenda item, see A/RES/55/215, A/RES/56/76 and A/RES/58/129.

<sup>2</sup> The impetus for developing partnerships between the United Nations and non-State actors was the United Nations Millennium Declaration (General Assembly resolution 55/2), in which heads of State and Government, with the prospect of a more effective United Nations, resolved to give greater opportunities to the private sector, non-governmental organizations and civil society, in general, to contribute to the realization of the Organization's goals and programmes (*ibid.*, para. 30).

<sup>3</sup> For the earlier reports of the Secretary-General that discuss partnerships in the context of the Organization's reform and renewal, see report of the Secretary-General "Renewing the United Nations: A Programme for Reform" (A/51/950), Action 17; report of the Secretary-General "We the peoples: the role of the United Nations in the twenty-first century" (A/54/2000), section VI.B; report of the Secretary-General "Cooperation between the United Nations and all relevant partners, in particular the private sector" (A/56/323); report of the Secretary-General "Strengthening of the United Nations: an agenda for further change" (A/57/387), section IV.C; and annual reports of the Secretary-General to the General Assembly on the work of the Organization (A/56/1(Supp), A/57/1(Supp) and A/58/1(Supp)).

<sup>4</sup> A/58/227, summary.

3. In its resolution 58/129, adopted after consideration of the Secretary-General's report (A/58/227), the General Assembly encourages the relevant United Nations bodies and agencies, and invites the Bretton Woods institutions, as well as the World Trade Organization, to continue exploring the possible uses of partnerships to better implement their goals and programmes. It also gives policy guidance on the formulation of principles and approaches to govern those partnerships.<sup>5</sup> In particular, they should be based on the United Nations purposes and principles, as set out in the Charter of the United Nations, and a common and systematic approach to partnerships should include the following principles: (i) common purpose; (ii) transparency; (iii) give no unfair advantages to any partner of the United Nations; (iv) mutual benefit and mutual respect; (v) accountability; (vi) respect for the modalities of the United Nations; (vii) balanced representation of relevant partners from developed and developing countries and countries with economies in transition; (viii) sectoral and geographic balance; and (ix) maintenance of the independence and neutrality of the United Nations system in general and the agencies in particular. The General Assembly also stresses that partnerships should be consistent with national laws, development strategies and plans, as well as the priorities of the countries in which the partnerships are implemented, and should be designed and implemented in a transparent and accountable manner. It calls upon all bodies within the United Nations system that engage in partnerships to ensure the integrity and independence of the Organization and to include information on partnerships in their regular reporting, as appropriate, on web sites and through other means.

4. The Commission has a long history of relationships with non-State actors. Relationships have generally been established for the purpose of engaging non-State actors in the formulation of its texts, in particular by inviting international non-governmental organizations to sessions of the Commission and its intergovernmental working groups, as well as promoting texts adopted by the Commission and offering technical assistance related to UNCITRAL texts. It has often been pointed out during that process that the participation of international non-governmental organizations in the deliberations of the Commission and its working groups was crucial for the quality and acceptance of the texts worked on by the Commission.

5. The need for more active engagement of non-State actors in the implementation of different aspects of the Commission's mandate was stressed by the Office of Internal Oversight Services (OIOS) in its report on the in-depth evaluation of legal affairs.<sup>6</sup> OIOS recommended that to increase coordination with

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<sup>5</sup> Developing generic partnership tools and guidelines has been identified by the Secretary-General as one of the challenges ahead. Up to now, partnerships in general have been regulated by internal guidelines of United Nations entities based upon the special guidelines for cooperation between the United Nations and business community adopted by the Secretary-General in July 2000 (document A/56/323, annex III). A process of review of practical experience gained since the launch of the guidelines is under way to update the guidelines and ultimately improve the dynamics of partnerships, while securing the Organization's security and independence. The review process is being conducted by a panel of a group of eminent persons assembled by the Secretary-General in February 2003. The panel has been entrusted with the review of past and current practices and preparation of a set of practical recommendations on how to make the interaction between the civil society and the United Nations more meaningful.

<sup>6</sup> E/AC.51/2002/5.

trade law organizations and ensure a concerted approach to common issues, the Commission's secretariat should meet annually with key organizations working on trade law issues to share information and workplans.<sup>7</sup> It also recommended that the Commission's secretariat formulate a strategy to work jointly with funding agencies supporting trade-related programmes to increase the range and breadth of its technical assistance in the field of trade law reform to promote appreciation and use of UNCITRAL texts, as well as devise a strategy to enhance contributions to UNCITRAL trust funds and explore new funding from the private sector.<sup>8</sup>

6. As mentioned in the note by the Secretariat on training and technical assistance to the thirty-seventh session of the Commission (A/CN.9/560), the resources of UNCITRAL have recently been strengthened to enable the Secretariat to carry out functions with respect to technical legislative assistance, dissemination of information on legal developments in the field of international trade law and to coordinate the work of international organizations active in the field of international trade effectively and in a timely fashion.<sup>9</sup> Partnerships with non-State actors, including the private sector, may be relevant to the implementation of these functions, in particular for the development of jointly sponsored activities and as a source of funding and technical expertise. Furthermore, with its convening power, neutrality, integrity, expertise and ability to motivate State and non-State actors, the Commission may play an active role as a framework-provider and facilitator to promote existing partnerships, facilitate the building of new partnerships, especially between non-State actors of developed and developing countries, and serve as a focal point for discussions on partnerships that promote unification and modernization of international trade law. Other partnerships across the United Nations system, in particular those with networks and presence in different parts of the world, may also be relevant to the Commission's work. Among them, the Global Compact is emerging as an overall value framework for developing partnerships between the United Nations and the business community. Launched in July 2000 and encompassing five core United Nations agencies (ILO, UNEP, the Office of the United Nations High Commissioner for Human Rights, UNDP and UNIDO, with the association of other United Nations agencies), private companies worldwide, international trade unions, non-governmental organizations, and academic institutions, the Global Compact seeks to advance good corporate citizenship by integrating nine universally agreed principles in the areas of human rights, labour and environment into business activities through a range of activities and engagement mechanisms. The principles were selected on the basis of, firstly, having been developed through international intergovernmental agreements and, secondly, having operational and strategic relevance to the private sector. Under the selected principles in the area of human rights, business should: (i) support and respect the protection of internationally proclaimed human rights (*Principle 1*); and (ii) make sure not to be complicit in human rights abuses (*Principle 2*). Under the selected principles in the area of labour standards, business should uphold: (i) the freedom of association and the effective recognition of the right to collective bargaining (*Principle 3*); (ii) the elimination of all forms of forced and compulsory labour (*Principle 4*); (iii) the effective abolition of child labour (*Principle 5*); and

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<sup>7</sup> Ibid., recommendation 13.

<sup>8</sup> Ibid., recommendation 14.

<sup>9</sup> A/CN.9/560, para. 4.

(iv) the elimination of discrimination in respect of employment and occupation (*Principle 6*). The last three selected principles embrace the area of environment and provide that business should: (i) support a precautionary approach to environmental challenges (*Principle 7*); (ii) undertake initiatives to promote greater environmental responsibility (*Principle 8*); and (iii) encourage the development and diffusion of environmentally friendly technologies (*Principle 9*).<sup>10</sup>

7. The Commission may wish to discuss its working methods and those of its Secretariat in the context of the participation of non-State actors as observers in the sessions of the Commission and its working groups; in that connection the Commission may wish to recognize that such participation has been widely regarded as useful and that it has contributed to the quality and acceptance of the texts worked on by the Commission. In addition, the Commission may wish to consider the formation of partnerships with non-State actors in pursuing the expansion of the technical legislative assistance activities of the Commission. The Commission may also wish to draw the attention of State members and observers to the initiatives across the United Nations that seek to assist private companies in pursuing socially responsible corporate governance. The Commission may recommend that State members and observers make these initiatives known to private enterprises in their own countries, and encourage the debate on global corporate responsibility at national and international levels.

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<sup>10</sup> A/56/323, Appendix I.



**I. UNCITRAL LEGISLATIVE GUIDE  
ON INSOLVENCY LAW**

[Issued as a United Nations publication, Sales No. E.05.V.10]



## II. EXPLANATORY NOTE ON THE UNITED NATIONS CONVENTION ON THE ASSIGNMENT OF RECEIVABLES IN INTERNATIONAL TRADE\*

(A/CN.9/557) [Original: English]

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\* This note has been prepared by the secretariat of the United Nations Commission on International Trade Law (UNCITRAL) for information purposes. It is not an official commentary on the Convention.

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## I. Introduction

1. The United Nations Convention on the Assignment of Receivables in International Trade was adopted and opened for signature by the General Assembly by its resolution 56/81 of 12 December 2001.<sup>1</sup> The Convention was prepared by the United Nations Commission on International Trade Law.<sup>2</sup>
2. The main objective of the Convention is to promote the availability of capital and credit at more affordable rates across national borders, thus facilitating the cross-border movement of goods and services. The Convention achieves this

<sup>1</sup> At its twenty-sixth to twenty-eighth sessions (1993-1995), the Commission considered three reports of the Secretary-General, namely, A/CN.9/378/Add.3 (*UNCITRAL Yearbook, Volume XXIV: 1993* (United Nations publication, Sales No. E.94.V.16)), A/CN.9/397 (*UNCITRAL Yearbook, Volume XXV: 1994* (United Nations publication, Sales No. E.95.V.20)) and A/CN.9/412 (*UNCITRAL Yearbook, Volume XXVI: 1995* (United Nations publication, Sales No. E.96.V.8)). The deliberations of the Commission on those reports are reflected in its reports on its twenty-sixth to twenty-eighth sessions (*Official Records of the General Assembly, Forty-eighth Session, Supplement No. 17* (A/48/17), paras. 297-301 (*UNCITRAL Yearbook, Volume XXIV: 1993*) (op. cit.); *ibid.*, *Forty-ninth Session, Supplement No. 17* (A/49/17), paras. 208-214 (*UNCITRAL Yearbook, Volume XXV: 1994*) (op. cit.) and *ibid.*, *Fiftieth Session, Supplement No. 17* (A/50/17), paras. 374-381 (*UNCITRAL Yearbook, Volume XXVI: 1995*) (op. cit.)). At its twenty-eighth session (1995), the Commission decided to entrust the Working Group on International Contract Practices with the task of preparing a uniform law on assignment in receivables financing. The draft convention was prepared by the Working Group at its twenty-fourth to thirty-first sessions (one more session of another Working Group, which was renamed for that session, its twenty-third session, was also held). For the reports of those sessions, see documents A/CN.9/420 (*UNCITRAL Yearbook, Volume XXVII: 1996* (United Nations publication, Sales No. E.89.V.7)), A/CN.9/432 and A/CN.9/434 (*UNCITRAL Yearbook, Volume XXVIII: 1997* (United Nations publication, Sales No. E.99.V.6)), A/CN.9/445 and A/CN.9/447 (*UNCITRAL Yearbook, Volume XXIX: 1998* (United Nations publication, Sales No. E.99.V.12)), A/CN.9/455 and A/CN.9/456 (*UNCITRAL Yearbook, Volume XXX: 1999* (United Nations publication, Sales No. E.00.V.9)), A/CN.9/466 (*UNCITRAL Yearbook, Volume XXXI: 2000* (United Nations publication, Sales No. E.02.V.3)) and A/CN.9/486 (*UNCITRAL Yearbook, Volume XXXII: 2001* (United Nations publication, Sales No. E.04.V.4)). For the papers prepared by the Secretariat and considered by the Working Group at those sessions, see A/CN.9/WG.II/WP.87 and A/CN.9/WG.II/WP.89 (*UNCITRAL Yearbook, Volume XXVIII: 1997*) (op. cit.), A/CN.9/WG.II/WP.93 and A/CN.9/WG.II/WP.96 (*UNCITRAL Yearbook, Volume XXIX: 1998*), A/CN.9/WG.II/WP.98 and A/CN.9/WG.II/WP.102 (*UNCITRAL Yearbook, Volume XXX: 1999*) (op. cit.) and A/CN.9/WG.II/WP.104 (*UNCITRAL Yearbook, Volume XXXI: 2000*) (op. cit.)).

<sup>2</sup> For information on UNCITRAL and its work, see the web site of the Commission ([www.uncitral.org](http://www.uncitral.org)). The deliberations of UNCITRAL on the draft convention are reflected in the reports on the work of its thirty-third (2000) and thirty-fourth (2001) sessions (*Official Records of the General Assembly, Fifty-fifth Session, Supplement No. 17* (A/55/17), paras. 12-192 (*UNCITRAL Yearbook, Volume XXXI A: 2000*) (op. cit.), and *Official Records of the General Assembly, Fifty-sixth Session, Supplement No. 17* and corrigendum (A/56/17 and Corr.3), paras. 13-200 (*UNCITRAL Yearbook, Volume XXXII: 2001*) (op. cit.)). Annex I of the report of UNCITRAL on the work of its thirty-third session (A/56/17 and Corr.3) contains the draft convention as submitted by the Commission to the General Assembly. At its thirty-third and thirty-fourth sessions, the Commission had before it versions of an analytical commentary on the draft convention, prepared by the Secretariat (A/CN.9/470 (*UNCITRAL Yearbook, Volume XXXI: 2000*) (op. cit.) and A/CN.9/489 and Add.1 (*UNCITRAL Yearbook, Volume XXXII: 2001*) (op. cit.)).

objective by reducing legal uncertainty with respect to a number of issues arising in the context of important receivables financing transactions, including asset-based lending, factoring, invoice discounting, forfaiting and securitization, as well as transactions in which no financing is provided.

3. The Convention establishes principles and adopts rules relating to the assignment of receivables. In particular, it removes statutory prohibitions to the assignment of future receivables and of receivables that are not specifically identified (bulk assignments). It also removes contractual limitations to the assignment of trade receivables, agreed between the parties to the contract from which the assigned receivables arise, and clarifies the effect of an assignment on rights securing payment of the assigned receivables. In addition, the Convention recognizes party autonomy and provides a set of non-mandatory rules applicable in the absence of an agreement between the parties to the assignment. Moreover, it addresses legal barriers to the collection of receivables from foreign debtors by providing a uniform set of rules on debtor-related issues, such as notification of the debtor, discharge of the debtor by payment and defences and rights of set-off of the debtor.

4. Most importantly, the Convention removes the existing uncertainty with respect to the law applicable to conflicts as to who is entitled to receive payment as between an assignee and a competing claimant, such as another assignee, creditors of the assignor or the administrator in the insolvency of the assignor. This is achieved by subjecting priority conflicts to a single law, one that is easy to determine and is most likely to be the place in which the main insolvency proceeding with respect to the assignor will be opened (i.e. the place of the assignor's place of business and, in the case of places of business in more than one State, the law of the State in which the assignor has its central administration). The Convention also addresses the non-recognition of rights in proceeds in many countries by providing a uniform limited priority rule with respect to proceeds, which aims to facilitate practices, such as securitization and undisclosed invoice discounting. In addition, it provides guidance to States wishing to modernize their substantive law priority rules by providing model substantive law priority rules.

5. Furthermore, the Convention enhances uniformity of the law applicable to assignment by including a set of conflict-of-laws rules. These rules are designed to fill gaps left in the Convention on issues governed but not explicitly settled in it. They may apply if the State in which a dispute arises has adopted the Convention.

6. A summary of the main features and provisions of the Convention is given below.

## **II. Scope of application**

### **A. Assignment/assignor-assignee-debtor/receivable**

7. "Assignment" is defined in the Convention as a transfer of property in receivables by agreement (art. 2). The definition covers both the creation of security rights in receivables and the transfer of full property in receivables, whether or not for security purposes. The Convention, however, does not specify what constitutes either an outright or a security transfer, leaving this issue to law applicable outside the Convention. An "assignment" may be a contractual subrogation or a pledge-type

transaction. On the other hand, it may not be a transfer by operation of law (e.g. statutory subrogation) or other non-contractual assignment.

8. The “assignor” is the creditor in the original contract giving rise to the assigned receivable. The assignor is either a borrower (or a third party) assigning receivables as security or a seller of receivables. The “assignee” is the new creditor, a lender or a buyer of receivables. The “debtor” is the obligor in the contract from which the assigned receivables arise (“original contract”).

9. The Convention defines a “receivable” as a “contractual right to payment of a monetary sum”. The definition includes parts of and undivided interests in receivables. Receivables from any type of contract are included. While the exact meaning of the term “contractual right” is left to national law, claims from contracts for the supply of goods, construction and services are clearly covered, whether the contracts are commercial or consumer contracts. Also included are loan receivables, intellectual property licence royalties, toll road receipts and monetary damage claims for breach of contract, as well as interest and non-monetary claims convertible to money. The term does not include a right to payment arising other than by contract, such as a tort claim or a tax refund claim.

## **B. Practices covered**

10. In view of the broad definition of the terms “assignment” and “receivable”, the Convention applies to a wide array of transactions. In particular, it covers the assignment of trade receivables (arising from the supply of goods, construction or services between businesses), loan receivables (arising from the extension of credit), consumer receivables (arising from consumer transactions) and sovereign receivables (arising from transactions with a governmental authority or a public entity). As a result, asset-based financing (e.g. revolving credit facilities and purchase-money financing) is covered. Factoring and forfaiting are also covered in all their variants (e.g. invoice discounting, maturity factoring and international factoring). The Convention also covers financing techniques, such as securitization of contractual receivables, as well as project financing on the basis of the future income flow of a project.

## **C. Exclusions and other limitations**

11. The scope of assignments covered is restricted by way of outright or limited exclusions of some types of receivable or assignment. The Convention excludes some assignments because no market exists for them (art. 4, para. 1). For example, assignments to a consumer are excluded; however, assignments of consumer receivables are covered. The Convention also excludes the assignment of those types of receivable which are already sufficiently regulated, or for which some of the provisions of the Convention may not be suitable, such as assignments of receivables arising from securities (whether directly or indirectly held), letters of credit, independent guarantees, bank deposits, derivative and foreign exchange transactions, payment systems and so forth (art. 4, para. 2).

12. Beyond the outright exclusion of certain types of assignment or receivable, the Convention provides two further types of limitation. One type is the “hold

harmless” clause, which applies to assignments of receivables in the form of negotiable instruments, consumer receivables and real estate receivables (art. 4. paras. 3-5). The Convention applies to the assignment of such receivables. However, it does not change the legal position of certain parties to such assignments. For example, the priority of a holder in due course under the law governing negotiable instruments is preserved.

13. The Convention places another type of limitation upon the scope of the provision granting effectiveness to assignments notwithstanding anti-assignment and similar clauses (arts. 9 and 10). Articles 9 and 10 apply only to trade receivables, broadly defined to include receivables from the supply or lease of goods or the provision of services other than financial services (arts. 9, para. 3, and 10, para. 4). They do not apply to assignments of other receivables, such as loan or insurance receivables. The result of this limitation to the scope of articles 9 and 10 is that the effectiveness of an anti-assignment clause in an assignment outside the scope of articles 9 and 10 is subject to law outside the Convention (which, under article 29, is the law governing the original contract).

#### **D. Definition of “internationality”**

14. As it focuses on international trade, the Convention applies in principle only to assignments of international receivables and to international assignments of receivables (art. 3). An assignment is international if the assignor and the assignee are located in different States. A receivable is international if the assignor and the debtor are located in different States. The international character of an assignment or a receivable is determined by the location of the assignor and the assignee, or the debtor, at the time of the conclusion of the assignment contract (a subsequent change does not affect the application of the Convention).

15. The Convention generally does not apply to domestic assignments of domestic receivables. Two exceptions exist, however. The first relates to subsequent assignments where, for example, A assigns to B, B to C, and so on. In order to ensure consistent results, the Convention applies to such subsequent assignments irrespective of whether the subsequent assignments are international or relate to international receivables, provided that any prior assignment in the chain of subsequent assignments is governed by the Convention (art. 1, para. 1 (b)). The second exception speaks to conflicts of priority between a domestic and a foreign assignee of domestic receivables (i.e. assignee A in country X and assignee B in country Y; the receivables are owed by a debtor in country Y). To ensure certainty as to the priority rights of assignees, the Convention covers the priority conflict between assignee A and assignee B even though the assignment to B is a domestic assignment of domestic receivables (arts. 5 (m) and 22).

#### **E. Connecting factors for the application of the Convention**

16. With the exception of the debtor-related provisions (e.g. arts. 15-21), the Convention applies to international assignments and to assignments of international receivables if the assignor is located in a State that is a party to the Convention (art. 1, para. 1 (a)). The Convention may apply to subsequent assignments that may



be wholly domestic even if the assignor is not located in a contracting State as long as a prior assignment is governed by the Convention (art. 1, para. 1 (b)).

17. For the debtor-related provisions to apply, the debtor too should be located in a State party to the Convention or the law governing the assigned receivables should be the law of a State party to the Convention (art. 1, para. 3). This approach protects the debtor from being subject to a text of which it could not be aware. It does not, however, exclude the application of the Convention's rules that have no effect on the debtor, such as the rules dealing with the relationship between the assignor and the assignee or those dealing with priority among competing claimants. Accordingly, even if the debtor-related provisions do not apply to a particular assignment, the balance of the Convention may still apply to the relationship between the assignor and the assignee or the assignee and a competing claimant.

18. The autonomous conflict-of-laws rules of the Convention may apply even if the assignor or the assignee is not located in a contracting State as long as a dispute is brought before a court in a contracting State (art. 1, para. 4).

## **F. Definition of “location”**

19. The meaning of the term “location” has an impact on the application of the Convention (i.e. on the international character of an assignment or a receivable and on the territorial scope of the Convention). It also has an impact on the law governing priority (art. 22). The Convention defines “location” by reference to the place of business of a person, or the person's habitual residence, if there is no place of business. Departing from the traditional “location rule”, referring in the case of multiple places of business to the place with the closest relationship to the relevant transaction, the Convention provides that, when an assignor or an assignee has places of business in more than one State, reference shall be made to the place of central administration (in other terms, the principal place of business or the main centre of interests). The reason for this approach is to provide certainty with respect to the application of the Convention as well as to the law governing priority. In contrast, when a debtor has places of business in more than one State, reference is to be made to the place most closely connected to the original contract. This different approach was taken with regard to the location of the debtor so as to ensure that the debtor is not surprised by the application of legal rules to which the original contract between the debtor and the assignor has no apparent relationship.

20. In the case of transactions made through branch offices, the central administration location rule will result in the application of the Convention rather than the law of the State in which the relevant branch is located, if the assignor has its central administration in a State party to the Convention. In addition, a transaction may become international and fall under the Convention if the assignee has its central administration in a State other than the State in which the assignor is located, even though the assignee acted through a branch located in the same State as the assignor. Moreover, the central administration location rule will result in the application of the law of the assignor's central administration (rather than the place with the closest relationship to the assignment) to priority disputes. Certainty in the application of the Convention and in the determination of the law governing priority justify such a result. This rule will not affect a financing institution as a debtor of

the original receivable because, in such a case, the close connection test determines the institution's location.

### **III. General provisions**

#### **A. Definitions and rules of interpretation**

21. Important terms such as "future receivable", "writing", "notification", "location", "priority", "competing claimant" and "financial contract" are defined in article 5.

#### **B. Party autonomy**

22. The Convention recognizes the right of the assignor, the assignee and the debtor to derogate from or vary by agreement provisions of the Convention (art. 6). There are two limitations: firstly, such an agreement cannot affect the rights of third parties; and, secondly, the debtor may not waive certain defences (art. 19, para. 2).

#### **C. Interpretation**

23. The Convention contains a general rule that its interpretation should be with a view to its object and purpose as set forth in the preamble, its international character and the need to promote uniformity in its application and the observance of good faith in international trade. Gaps left with respect to matters covered but not expressly settled in the Convention are to be filled in accordance with its general principles and, in the absence of a relevant principle, in accordance with the law applicable by virtue of the rules of private international law, including those of the Convention if they are applicable (art. 7).

### **IV. Effects of assignment**

#### **A. Formal and material validity**

24. Owing to the lack of consensus in the Commission, the Convention does not contain a uniform substantive law rule as to the formal validity of the assignment. However, it does contain conflict-of-laws rules. The form of an assignment as a condition of priority is referred to the law of the assignor's location (arts. 5 (g) and 22). Moreover, a conflict-of-laws rule for formal validity of the contract of assignment as between the parties thereto is contained in the autonomous conflict-of-laws rules of the Convention (art. 27).

25. An assignment made by agreement between the assignor and the assignee is effective if it is otherwise effective as a matter of contract (arts. 2 and 11). No notification is required for the assignment to be effective (art. 14, para. 1). The Convention focuses on statutory and contractual limitations, as well as on the impact of assignment on security and other supporting rights. Other issues related to

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material validity or effectiveness are addressed in the context of the relationship in which they may arise (assignor-assignee or debtor-assignee or assignee-third party).

## **B. Statutory limitations**

26. In order to facilitate receivables financing, the Convention sets aside statutory and other legal limitations with respect to the assignability of certain types of receivable (e.g. future receivables) or the effectiveness of certain types of assignment (e.g. bulk assignments) that are typical in receivables financing transactions. It is sufficient if receivables are identifiable as receivables to which the assignment relates at the time of assignment or, in the case of future receivables, at the time of conclusion of the original contract. One act is sufficient to assign several receivables, including future receivables (art. 8). Apart from the statutory limitations mentioned, other statutory limitations, such as those relating to personal or sovereign receivables, are not affected by the Convention.

## **C. Contractual limitations**

27. The Convention validates an assignment of trade receivables (broadly defined in art. 9, para. 3) made in violation of an anti-assignment clause without eliminating the liability that the assignor may have for breach of contract under law applicable outside the Convention and without extending that liability to the assignee (art. 9, para. 1). However, if such liability exists, the Convention narrows its scope by providing that mere knowledge of the anti-assignment agreement, on the part of the assignee that is not a party to the agreement, does not constitute sufficient ground for liability of the assignee for the breach of the agreement. In addition, the Convention protects the assignee further by ensuring that the violation of an anti-assignment clause by the assignor is not in itself sufficient ground for the avoidance of the original contract by the debtor (art. 9, para. 2). Furthermore, the Convention does not allow a claim for breach of an anti-assignment clause to be made by the debtor against the assignee by way of set-off so as to defeat the assignee's demand for payment (art. 18, para. 3).

28. With respect to consumers, the approach of the Convention is based on the assumption that this provision does not affect them, since anti-assignment clauses are very rare in consumer contracts. In any case, if there is a conflict between the Convention and applicable consumer-protection law, consumer-protection law will prevail (art. 4, para. 4). With respect to the assignment of sovereign receivables, States may enter a reservation with regard to article 9 (art. 40). This exception is intended to protect a limited number of States that do not have a policy of protecting themselves by statute, but instead rely on contractual limitations.

## **D. Transfer of rights securing payment of the assigned receivables**

29. An accessory right, whether personal or property, securing payment of the assigned receivable is transferred with the receivable without a new act of transfer. The assignor is obliged to transfer to the assignee an independent security or other supporting right (art. 10, para. 1). With respect to contractual limitations on

assignment, such rights are treated in the same way as a receivable (art. 10, paras. 2 and 3). This provision likewise applies to “trade receivables” defined broadly (art. 10, para. 4) and does not affect any obligations of the assignor towards the debtor under the law governing the security or other supporting right (art. 10, para. 5). Similarly, this provision does not affect any form or registration requirement necessary for the transfer of the security right (art. 10, para. 6).

## **V. Rights, obligations and defences**

### **A. Assignor and assignee**

#### **1. Party autonomy and rules of practice**

30. The Convention recognizes the right of the assignor and the assignee to structure their contract in any way they wish to meet their particular needs, as long as they do not affect the rights of third parties (arts. 6 and 11). The Convention also gives legislative strength to trade usages agreed upon by the assignor and the assignee and trade practices established between such parties. Moreover, the Convention includes certain non-mandatory rules that are applicable to the relationship between the assignor and the assignee. Those rules are meant to provide a list of issues to be addressed in the contract and, at the same time, to fill gaps left in the contract with respect to matters, such as representations of the assignor, notification and payment instructions, as well as rights in proceeds. They are suppletive rules only. The parties may always agree to modify the rules as they operate between them.

#### **2. Representations**

31. With respect to representations, the Convention follows generally accepted principles and attempts to establish a balance between fairness and practicality (art. 12). For example, unless otherwise agreed, the risk of hidden defences on the part of the debtor is placed on the assignor. The Convention follows this approach, in view of the fact that the assignor is the contractual partner of the debtor and thus is in a better position to know whether there will be problems with the contract’s performance that may give the debtor rights of defence.

#### **3. Notification and payment instructions**

32. Unless otherwise agreed, the assignor, the assignee or both may send the debtor a notification and a payment instruction. The assignee is given an independent right to notify the debtor and request payment. This independent right is essential where the assignee’s relationship with the assignor becomes problematic and the assignor is unlikely to cooperate with the assignee in notifying the debtor. After notification, only the assignee may request payment (art. 13). Notification of the debtor in violation of an agreement between the assignor and the assignee would still permit the debtor to obtain a discharge if it pays in accordance with such a notification, but the claim for breach of contract between the assignor and the assignee is preserved.

33. Payment instructions do not fall within the definition of notification of the assignment (art. 5 (d)). This means that a notification need not provide a change in

payment instructions to the debtor, but may be given mainly to freeze the debtor's defences and rights of set-off (art. 18, para. 2).

#### **4. Rights in proceeds**

34. The Convention introduces a contractual right to proceeds of receivables and proceeds of proceeds ("whatever is received in respect of an assigned receivable", art. 5 (j)). As between the assignor and the assignee, the assignee may claim proceeds if payment is made to the assignee, to the assignor or to another person over whom the assignee has priority (art. 14). Whether the assignee may retain or claim a proprietary right in such proceeds is generally an issue left to law applicable outside the Convention. However, if the proceeds are themselves receivables, this issue is left to the law of the assignor's location (arts. 5 (j) and 22). In addition, in certain circumstances, the Convention's limited substantive proceeds rule may apply (art. 24).

### **B. Debtor**

#### **1. Debtor protection**

35. An assignment does not affect the debtor's legal position without the debtor's consent, unless a provision of the Convention clearly states otherwise. Furthermore, the assignment cannot change the currency or the State in which payment is to be made without the debtor's consent (arts. 6 and 15).

36. Beyond generally codifying the principle of debtor protection, the Convention contains a number of specific expressions of this principle. These provisions deal with the debtor's discharge by payment, defences, rights of set-off, waivers of such defences or rights of set-off, modification of the original contract and recovery of payments by the debtor.

#### **2. Debtor's discharge by payment**

37. The debtor may be discharged by paying in accordance with the original contract, unless the debtor receives notification of the assignment. After receiving such notification, the debtor is discharged by paying in accordance with the written payment instructions and, in the absence of such instructions, by paying the assignee (art. 17, paras. 1 and 2). The notification of the assignment thereby determines the method by which the debtor shall be discharged. The notification must be written in a language that is reasonably expected to be understood by the debtor and must reasonably identify the assigned receivables and the assignee (art. 16).

38. Whether the debtor knew or ought to have known of a previous assignment of which it did not receive a notification is irrelevant. The Convention adopts this approach so as to ensure an acceptable level of certainty as to debtor discharge, which is an important element in pricing a transaction by the assignee. This approach encourages neither bad faith nor fraud. It is always difficult to prove what the debtor knew or ought to have known and, in any case, the Convention does not override national law provisions on fraud.

39. The Convention also provides a series of rules concerning multiple notifications or payment instructions. When the debtor receives several payment instructions that relate to a single assignment of the same receivable by the same assignor, the debtor is discharged by paying in accordance with the last payment instruction received (art. 17, para. 3). Where several notifications relate to more than one assignment of the same receivables by the same assignor, the debtor is discharged by paying in accordance with the first notification received (art. 17, para. 4). In the case of several notifications relating to subsequent assignments, the debtor is discharged by paying in accordance with the notification of the last of such subsequent assignments (art. 17, para. 5).

40. When the debtor receives several notifications relating to parts of, or undivided interests in, one or more receivables, it has a choice. The debtor may obtain a discharge by paying either in accordance with the notifications received or in accordance with the Convention as if no notification had been received (art. 17, para. 6). By giving the debtor, in effect, the right to determine whether or not the notification of a partial assignment is effective with respect to debtor discharge, the Convention avoids overburdening the debtor with the obligation of dividing its payment. This approach does not invalidate partial assignments. Rather, it merely suggests that assignors or assignees need to structure payments taking into account that the debtors need not agree to partial payments (e.g. according to the provisions of art. 24, para. 2). The assignor and the assignee may also divide payments with the debtor's consent obtained at the time of the conclusion of the original contract or the assignment or at a subsequent point of time.

41. One of the key debtor-protection provisions allows the debtor to request adequate proof of the assignment when the assignee gives notification without the cooperation or apparent authorization of the assignor (art. 17, para. 7). This right is intended to safeguard the debtor from the risk of having to pay an unknown third party. "Adequate proof" includes any writing with the assignor's signature indicating that the assignment occurred, such as the assignment contract or an authorization for the assignee to notify. If the assignee does not provide such proof within a reasonable period of time, the debtor may obtain a discharge by paying the assignor.

42. The Convention does not affect any rights the debtor may have under law outside the Convention to discharge its obligation by payment to the person entitled to payment, to a competent judicial or other authority, or to a public deposit fund (art. 17, para. 8). For example, if the debtor is discharged under law outside the Convention by complying with a notification that does not meet the Convention's requirements, the Convention recognizes this result. Similarly, payment to a public deposit fund under law outside the Convention is recognized in the Convention as a valid discharge where payment to such a fund is recognized under law outside the Convention.

### **3. Debtor defences and rights of set-off**

43. With respect to the debtor's defences and rights of set-off, the Convention codifies generally accepted rules. The debtor may raise against the assignee any defences or rights of set-off that the debtor could have raised in a claim against the assignor. Rights of set-off arising from the original contract or a related transaction may be raised against the assignee even if they become available to the debtor after

notification (art. 18, para. 1). However, rights of set-off that do not arise from the original contract or a related transaction, and become available to the debtor after notification, may not be raised against the assignee (art. 18, para. 2). The Convention leaves the meaning of “become available” (i.e. whether the right has to be quantified, has matured or has become payable) to be determined by the applicable law outside the Convention (for rights of set-off arising from the original contract, that law is, under article 29, the law governing the original contract).

#### **4. Waiver of defences**

44. The debtor may waive its defences and rights of set-off by agreement with the assignor. To warn the debtor of the important consequences of the waiver, the Convention requires a writing signed by the debtor for a waiver or its modification (art. 19, para. 1). In order to protect the debtor from undue pressure by the assignor, the Convention also prohibits waiver of defences or rights of set-off arising from fraudulent acts of the assignee or based on the debtor’s incapacity (art. 19, para. 2).

#### **5. Modification of the original contract**

45. Often, the original contract needs to be modified to meet the changing needs of the parties. The agreement itself determines the *inter partes* effects of such modifications. The Convention addresses the third-party effects, such as whether the debtor can pay to the assignee the receivable as modified to be discharged, and whether the assignee can claim payment of the receivable as modified. The basic rule provides that, up until notification of the debtor, any contract modification is effective as against the assignee and the assignee acquires the receivable as modified (art. 20, para. 1). After notification, without the assignee’s consent, such a modification is ineffective as against the assignee of a receivable earned by performance but is effective against the assignee of an unearned receivable if the modification was provided for in the original contract or a reasonable assignee would have consented to the modification (art. 20, para. 2). The Convention does not affect any liability of the assignor towards the assignee under applicable law for breach of an agreement not to modify the original contract (art. 20, para. 3).

#### **6. Recovery of payments by the debtor**

46. The debtor may recover only from the assignor payments made to the assignor or the assignee (art. 21). This, in effect, means that the debtor bears the risk of insolvency of its contractual partner, which would be the case even in the absence of an assignment.

### **C. Third parties**

#### **1. Law applicable to priority in receivables**

47. One of the most important parts of the Convention deals with the impact of assignment on third parties, such as competing assignees, other creditors of the assignor and the administrator in the insolvency of the assignor. This issue is addressed in the Convention as an issue of priority among competing claimants, that is, of who is entitled to receive payment or other performance first. As the

assignor's assets may not be sufficient to satisfy all creditors, this issue is of considerable importance.

48. As there was no consensus in the Commission on a substantive law priority rule, the Convention addresses this issue through conflict-of-laws rules (arts. 22-24). The value of these rules lies in the fact that, deviating from traditional approaches, they centralize all priority conflicts to the law of the assignor's location. Because "location" means the place of central administration, if the assignor has a place of business in more than one State, the Convention thereby refers priority conflicts to the law of a single, and easily determinable, jurisdiction. In addition, the main insolvency proceeding with regard to the assignor will most often be opened in this jurisdiction, a result that makes conflicts between secured transactions and insolvency laws easier to address.

49. In order to cover all possible priority conflicts, the term "competing claimant" is defined so as to include other assignees, even if both the assignment and the receivable are domestic and thus otherwise outside the Convention's scope, other creditors of the assignor, including creditors with rights in other property extended by law to the assigned receivable, such as creditors with a proprietary right in the receivable created by court decision or a retention of title in goods extended by law to the receivables from the sale of the goods, and the administrator in the insolvency of the assignor (art. 5 (m)). The definition of the term "priority" covers not only the preference in payment or other satisfaction but also related matters, such as the determination of whether that right is a personal or a property right, whether or not it is a security right and whether any required steps to render the right effective against a competing claimant have been satisfied (art. 5 (g)). Priority does not generally cover the effectiveness of an assignment as between the assignor and the assignee or the debtor (arts. 5 (g), 8 and 22, "with the exception of matters that are settled elsewhere in this Convention").

## **2. Mandatory law and public policy exceptions**

50. A mandatory law priority rule of the forum State may result in setting aside the applicable priority rule of the assignor's law if the latter's application is "manifestly contrary to the public policy of the forum State" (art. 23, para. 1). Mandatory law rules of the forum State or another State may not prevent in and of themselves the application of a priority provision of the assignor's law (art. 23, para. 2). However, in the case of insolvency proceedings in a State other than the State of the assignor's location, the forum State may apply its own mandatory priority rule giving priority to certain types of preferential creditor, such as tax or wage claimants (art. 23, para. 3). Moreover, the Convention is not intended to interfere with substantive and procedural insolvency rules of the forum State that do not affect priority as such (e.g. avoidance actions, stays on collection of receivables assigned and the like).

## **3. Law applicable to priority in proceeds**

51. The Convention does not contain a general rule on the law applicable to priority in proceeds. The reason lies in the differences between legal systems with respect to the nature and the treatment of rights in proceeds. However, the Convention contains two limited proceeds rules. Under the first one, if the assignee has priority over other claimants with respect to receivables and proceeds are paid directly to the assignee, the assignee may retain the proceeds (art. 24, para. 1). The



second rule is intended to facilitate practices such as securitization and undisclosed invoice discounting. In such practices, payments are channelled to a special account held by the assignor, separately from its other assets, on behalf of the assignee. The Convention provides that, if the assignee has priority over other claimants with respect to the receivables and the proceeds are kept by the assignor on behalf of the assignee and are reasonably identifiable from the other assets of the assignor, the assignee has the same priority with respect to proceeds (art. 24, para. 2). The Convention does not address, however, a priority conflict between an assignee claiming an interest in proceeds held in a deposit or securities account and the depositary bank or the securities broker or other intermediary with a security or set-off right in the account (art. 24, para. 3).

#### **4. Substantive law priority rules**

52. In order to obtain the benefit of the Convention's priority rules, parties have the opportunity to structure their transactions in a way that refers priority questions to the appropriate law (e.g. by creating special entities in appropriate locations). The question remains as to what should happen if this is impossible, or is only possible at a considerable cost, and the applicable law has insufficient priority rules. In order to address this question, the Convention offers model substantive priority provisions (annex). States have a choice between three substantive priority systems if they wish to change their existing rules. One is based on filing of a notice about the assignment, another is based on notification of the debtor and the third is based on the time of assignment. States that wish to adjust their legislation may, by declaration, select one of these priority regimes, or simply enact new priority rules or revise their existing priority rule by way of domestic legislation. The assumption is that, in an environment of free competition between legal regimes, the regime with the most economic benefits will prevail.

#### **5. Subordination agreements**

53. Parties involved in a priority conflict may negotiate and relinquish priority in favour of a subordinate claimant where commercial considerations so warrant. In order to afford maximum flexibility and to reflect prevailing business practices, the Convention makes it clear that a valid subordination need not take the form of a direct subordination agreement between the assignee with priority and the beneficiary of the subordination agreement (art. 25). It can also be effected unilaterally, for instance, by means of an undertaking of the first ranking assignee to the assignor, empowering the assignor to make a second assignment ranking first in priority.

## **VI. Autonomous conflict-of-laws rules**

### **A. Scope and purpose**

54. The Convention contains a set of conflict-of-laws rules that may apply independently of any territorial link with a State party to the Convention. In cases where the assignor, or the debtor, is located in a State party to the Convention, or the law governing the original contract is the law of a State party to the Convention, the independent conflict-of-laws rules may apply to fill gaps in the Convention,

unless an answer may be derived from the principles underlying the Convention. If the assignor, or the debtor, is not located in a State party to the Convention, or the law governing the receivable is not the law of a State party, the independent conflict-of-laws rules may apply to transactions to which the other provisions of the Convention would not apply (art. 26). Such transactions need to be international, as defined in the Convention, and should not be excluded from the scope of the Convention.

55. The autonomous conflict-of-laws rules of the Convention in chapter V are subject to a reservation. States that enter a reservation with respect to chapter V are not bound by it (art. 39). Such a reservation was allowed to ensure that States that wished to adopt the Convention would not be prevented from doing so merely because the autonomous conflict-of-laws rules were inconsistent with their own conflict-of-laws rules.

### **B. Law applicable to the form of the contract of assignment**

56. In the case of a contract of assignment concluded between persons located in the same State, formal validity of the contract of assignment is subject to the law of the State, which governs the contract, or of the State in which the contract is concluded. When a contract of assignment is concluded between persons located in different States, it is valid if it satisfies the formal requirements of either the law that governs the contract or the law of one of those States (art. 27).

### **C. Law applicable to the mutual rights and obligations of the assignor and the assignee**

57. The mutual rights and obligations of the assignor and the assignee are subject to the law of their choice. The parties' freedom of choice is subject to the public policy of the forum and the mandatory rules of the forum or a closely connected third country. In the absence of a choice by the parties, the law of the State with which the contract of assignment is most closely connected governs. The "close connection" test was adopted in this case despite the uncertainty it might cause as it is unlikely to have much impact in view of the fact that in the vast majority of cases parties choose the applicable law (art. 28).

### **D. Law applicable to the rights and obligations of the assignee and the debtor**

58. The relationship between the assignee and the debtor, the conditions under which the assignment can be invoked as against the debtor and contractual limitations on assignment are subject to the law governing the original contract. The fact that most of these issues are covered by the substantive law rules of the Convention limits the impact of this provision. However, certain issues were deliberately not covered in the substantive law rules of the Convention, such as the question as to when a right of set-off is available to the debtor under article 18. Article 29 governs that particular issue, at least with respect to transaction set-off (i.e. set-off arising from the original contract or another contract that was part of the

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same transaction). Another question falling within the scope of article 29 is the effect of anti-assignment clauses on assignments of receivables to which article 9 or 10 does not apply either because they relate to assignments of non-trade receivables or because the debtor is not located in a State party to the Convention. Statutory limitations, however, are not covered by article 29. While some statutory limitations aim to protect the debtor, many are intended to protect the assignor. In the absence of a way to draw a clear distinction between the various types of statutory limitation, it would be inappropriate to subject them to the law governing the original contract. In any case, with a few exceptions, the Convention does not affect statutory limitations.

### **E. Law applicable to priority**

59. The Convention refers issues of priority to the law of the assignor's location. The value of this rule is that it may apply to transactions to which article 22, which it repeats, does not apply because of the absence of a territorial connection between an assignment and a State party to the Convention.

## **VII. Final provisions**

60. The Convention will enter into force upon ratification by five States (art. 45). States may exclude further practices by declaration, but may not exclude practices relating to "trade receivables" broadly defined in articles 9, paragraph 3, and 10, paragraph 4 (art. 41). The Convention will not apply to such practices if the assignor is located in a State that has made such a declaration. The Convention prevails over the Unidroit Convention on International Factoring (the Ottawa Convention). However, this does not affect the application of the Ottawa Convention to the rights and obligations of a debtor if the Convention does not apply to that debtor (art. 38).



**III. BIBLIOGRAPHY OF RECENT WRITINGS  
RELATED TO THE WORK OF UNCITRAL  
NOTE BY THE SECRETARIAT  
(A/CN.9/566) [Original: English]**

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#### IV. CHECK-LIST OF DOCUMENTS OF THE UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW

<i>Document Symbol</i>	<i>Title or description</i>	<i>Location in Present volume</i>
<b>A. List of documents before the Commission at its thirty-seventh session</b>		
<i>1. General series</i>		
A/CN.9/541	Annotated provisional agenda and organization of work of the thirty-seventh session	Not reproduced
A/CN.9/542	Report of Working Group V (Insolvency Law) on the work of its twenty-ninth session (Vienna, 1-5 September 2003)	Part two, I, A
A/CN.9/543	Report of Working Group VI (Security Interests) on the work of its fourth session (Vienna, 8-12 September 2003)	Part two, V, A
A/CN.9/544	Report of Working Group III (Transport Law) on the work of its twelfth session (Vienna, 6-17 October 2003)	Part two, III, A
A/CN.9/545	Report of Working Group II (Arbitration) on the work of its thirty-ninth session (Vienna, 10-14 November 2003)	Part two, II, A
A/CN.9/546	Report of Working Group IV (Electronic Commerce) on the work of its forty-second session (Vienna, 17-21 November 2003)	Part two, IV, A
A/CN.9/547	Report of Working Group II (Arbitration) on the work of its fortieth session (New York, 23-27 February 2004)	Part two, II, C
A/CN.9/548	Report of Working Group IV (Electronic Commerce) on the work of its forty-third session (New York, 15-19 March 2004)	Part two, IV, F
A/CN.9/549	Report of Working Group VI (Security Interests) on the work of its fifth session (New York, 22-25 March 2004)	Part two, V, D
A/CN.9/550	Report of Working Group V (Insolvency Law) and Working Group VI (Security Interests) on the work of their second joint session (New York, 26 and 29 March 2004)	Part two, V, C
A/CN.9/551	Report of Working Group V (Insolvency Law) on the work of its thirtieth session (New York, 29 March-2 April 2004)	Part two, I, D
A/CN.9/552	Report of Working Group III (Transport Law) on the work of its thirteenth session (New York, 3-14 May 2004)	Part two, III, F
A/CN.9/553	Note by the Secretariat on possible future work in the area of public procurement	Part two, VI
A/CN.9/554	Report on the 5 <sup>th</sup> UNCITRAL-INSOL Judicial Colloquium on Cross-Border Insolvency, 2003	Part two, I, I
A/CN.9/555	Report on the UNCITRAL Colloquium on International Commercial Fraud	Part two, X, B
A/CN.9/556	[ <i>Not issued.</i> ]	
A/CN.9/557	Explanatory note on the United Nations Convention on the Assignment of Receivables in International Trade	Part three, I
A/CN.9/558	Compilation of comments by international organizations on the draft UNCITRAL legislative guide on insolvency law	Part two, I, J

<i>Document Symbol</i>	<i>Title or description</i>	<i>Location in Present volume</i>
A/CN.9/558/Add.1	Compilation of comments by Governments on the draft UNCITRAL legislative guide on insolvency law	Part two, I, J
A/CN.9/559 and Add.1-3	Draft UNCITRAL legislative guide on insolvency law: revisions to document A/CN.9/WG.V/WP.70	Part two, I, K
A/CN.9/560	Note by the Secretariat on training and technical assistance	Part two, VIII
A/CN.9/561	Note by the Secretariat on the status of conventions and model laws	Part two, IX
A/CN.9/562	Note by the Secretariat: introduction to the digest of case law on the United Nations Sales Convention	Not reproduced
A/CN.9/563 and Add.1	Note by the Secretariat: uniform interpretation of UNCITRAL texts; sample digest of case law on the UNCITRAL Model Law on International Commercial Arbitration (1985)	Not reproduced
A/CN.9/564	Note by the Secretariat on partnerships between the United Nations and non-state actors, in particular the private sector: recent developments across the United Nations and possible implications for the Commission's work	Part two, XI
A/CN.9/565	Note by the Secretariat on the coordination of work: activities of international organizations in the area of security interests	Part two, X, A
A/CN.9/566	Note by the Secretariat: bibliography of recent writings related to the work of UNCITRAL	Yearbook vol. XXXIV 2003, Part three, III
A/CN.9/WG.V/WP.70 (Parts I and II)	Draft legislative guide on insolvency law	Part two, I, E
A/CN.9/WG.V/WP.71	Note by the Secretariat on the treatment of security interests in the draft legislative guide on insolvency law	Part two, I, F
A/CN.9/WG.V/WP.72	Note by the Secretariat on the draft legislative guide on insolvency law	Part two, I, G

## *2. Restricted series*

A/CN.9/XXXVII/CRP.1 and Add.1-18	Draft report of the United Nations Commission on International Trade Law on the work of its thirty-seventh session	Not reproduced
A/CN.9/XXXVII/CRP.2	Agenda item 16 – other business – proposed strategic Framework for 2006-2007	Not reproduced
A/CN.9/XXXVII/CRP.3 and Rev.1	Draft resolution on adoption of the draft Legislative Guide on Insolvency Law	Not reproduced

## *3. Information series*

A/CN.9/XXXVII/INF.1	List of Participants	Not reproduced
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### **B. List of documents before the Working Group on Insolvency Law at its twenty-ninth session**

#### *1. Working papers*

A/CN.9/WG.V/WP.66	Provisional agenda	Not reproduced
A/CN.9/WG.V/WP.67	Working paper submitted to the Working Group	



<i>Document Symbol</i>	<i>Title or description</i>	<i>Location in Present volume</i>
	on Insolvency Law at its twenty-ninth session: Draft legislative guide on insolvency law	Part two, I, B
A/CN.9/WG.V/WP.68	Working paper submitted to the Working Group on Insolvency Law at its twenty-ninth session: Draft legislative guide on insolvency law	Part two, I, C
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A/CN.9/WG.V/XXIX/CRP.1 and Add.1-5	Draft report of the Working Group on Insolvency Law	Not reproduced
A/CN.9/WG.V/XXIX/CRP.2-5	Draft Legislative Guide on Insolvency Law	Not reproduced
<b>3. Information series</b>		
A/CN.9/WG.V/XXIX/INF.1	List of participants	Not reproduced
<b>C. List of documents before the Working Group on Insolvency Law at its thirtieth session</b>		
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A/CN.9/WG.V/WP.70 (Parts I and II)	Working paper submitted to the Working Group on Insolvency Law at its thirtieth session: Draft legislative guide on Insolvency Law	Part two I, E
A/CN.9/WG.V/WP.71	Working paper submitted to the Working Group on Insolvency Law at its thirtieth session: Draft legislative Guide on Insolvency Law	Part two I, F
A/CN.9/WG.V/WP.72	Working paper submitted to the Working Group on Insolvency Law at its thirtieth session: Draft legislative guide on Insolvency Law	Part two I, G
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A/CN.9/WG.V/XXX/CRP.1 and Add.1-6	Draft report of the Working Group on Insolvency Law on the work of its thirtieth session	Not reproduced
A/CN.9/WG.V/XXX/CRP.2-5	Draft report of the Working Group on Insolvency Law on the work of its thirtieth session	Not reproduced
<b>3. Information series</b>		
A/CN.9/WG.V/XXX/INF.1	List of Participants	Not reproduced

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A/CN.9/WG.VI/WP.9 and Add.1-4, Add.6-8	Working paper submitted to the Working Group on Security Interests at its fourth session: Draft legislative guide on secured transactions	Part two V, B
<i>2. Restricted series</i>		
A/CN.9/WG.VI/IV/CRP.1 and Add.1-6	Draft report of the Working Group on Security Interests on the work of its fourth session	Not reproduced
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<b>E. List of documents before the Working Group on Security Interests at its fifth session</b>		
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A/CN.9/WG.VI/WP.10	Provisional agenda	Not reproduced
A/CN.9/WG.VI/WP.11 and Add. 1-2	Working paper submitted to the Working Group on Security Interests at its fifth session: Draft legislative guide on secured transactions	Part two V, E
<i>2. Restricted series</i>		
A/CN.9/WG.VI/V/CRP.1 and Add.1-3	Draft report of the Working Group on Security Interests on the work of its fifth session	Not reproduced
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<b>F. List of documents before the Working Group on Transport Law at its twelfth session</b>		
<i>1. Working papers</i>		
A/CN.9/WG.III/WP.31	Provisional Agenda	Not reproduced
A/CN.9/WG.III/WP.28/Add.1	Working paper submitted to the Working Group on Transport Law at its twelfth session: Preparation of a draft instrument on the carriage of goods [by sea]: Compilation of replies to a questionnaire on door-to-door transport and additional comments by States and International organizations on the scope of the draft Instrument	Part two III, B

<i>Document Symbol</i>	<i>Title or description</i>	<i>Location in Present volume</i>
A/CN.9/WG.III/WP.32	Working paper submitted to the Working Group on Transport Law at its twelfth session: Draft instrument on the carriage of goods [wholly or partly][by sea]	Part two III, C
A/CN.9/WG.III/WP.33	Working paper submitted to the Working Group on Transport Law at its twelfth session: Preparation of a draft instrument on the carriage of goods [by sea]: Proposal by the Netherlands on the application door-to-door of the instrument	Part two III, D
A/CN.9/WG.III/WP.34	Working paper submitted to the Working Group on Transport Law at its twelfth session: Preparation of a draft instrument on the carriage of goods [by sea]: Proposal by the United States of America	Part two III, E
<b>2. Restricted series</b>		
A/CN.9/WG.III/XII/CRP.1 and Add.1-7	Draft report of the Working Group on Transport Law on the work of its twelfth session	Not reproduced
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<b>G. List of documents before the Working Group on Transport Law at its thirteenth session</b>		
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A/CN.9/WG.III/WP.36	Working paper submitted to the Working Group on Transport Law at its thirteenth session: Preparation of a draft instrument on the carriage of goods [wholly or partly][by sea]	Part two III, G
A/CN.9/WG.III/WP.37	Working paper submitted to the Working Group on Transport Law at its thirteenth session: Preparation of a draft instrument on the carriage of goods [by sea]: Proposal by China	Part two III, H
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A/CN.9/WG.III/XIII/CRP.1 and Add.1-11	Draft report of the Working Group on Transport Law on the work of its thirteenth session	Not reproduced
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<b>H. List of documents before the Working Group on Electronic Commerce at its forty-second session</b>		
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A/CN.9/WG.IV/WP.104 Add.1-4	Working paper submitted to the Working Group on Electronic Commerce at its forty-second session: Legal aspects of electronic commerce: Electronic Contracting: background information	Part two IV, C
A/CN.9/WG.IV/WP.105	Working paper submitted to the Working Group on Electronic Commerce at its forty-second session: Legal aspects of electronic commerce: Electronic Contracting: Comments by the International Chamber of Commerce	Part two IV, D
A/CN.9/WG.IV/WP.106	Working paper submitted to the Working Group on Electronic Commerce at its forty-second session: Legal aspects of electronic commerce: Electronic Contracting: Comments by the World Intellectual Property Organization	Part two IV, E

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A/CN.9/WG.VI/XLII/CRP.1 and Add.1-7	Draft report of the Working Group on Electronic Commerce on the work of its forty-second session	Not reproduced
A/CN.9/WG.VI/XLII/CRP.2 Add.1	Electronic contracting: provisions for a draft convention: Proposals by Germany	Not reproduced

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A/CN.9/WG.IV/WP107	Provisional agenda	Not reproduced
A/CN.9/WG.IV/WP.108	Working paper submitted to the Working Group on Electronic Commerce at its forty-third session: Legal aspects of electronic commerce: Electronic Contracting: provisions for a draft convention	Part two IV, G

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<b>J. List of documents before the Working Group on International Commercial Arbitration and Conciliation at its thirty-ninth session</b>		
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A/CN.9/WG.II/WP.124	Provisional Agenda	Not reproduced
A/CN.9/WG.II/WP.125	Working paper submitted to the Working Group on Arbitration at its thirty-ninth session: Settlement of commercial disputes: interim measures of protection	Part two II, B
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A/CN.9/WG.V/XXXIX/CRP.1 and Add.1-7	Draft report of the Working Group on Arbitration and Conciliation on the work of its thirty-ninth session	Not reproduced
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<b>K. List of documents before the Working Group on International Commercial Arbitration and Conciliation at its fortieth session</b>		
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A/CN.9/WG.II/WP.127	Working paper submitted to the Working Group on Arbitration at its fortieth session: Settlement of commercial disputes: interim measures of protection-liability regime	Part two II, D
A/CN.9/WG.II/WP.128	Working paper submitted to the Working Group on Arbitration at its fortieth session: Settlement of commercial disputes: interim measures of protection	Part two II, E
A/CN.9/WG.II/WP.129	Working paper submitted to the Working Group on Arbitration at its fortieth session: Settlement of commercial disputes: interim measures of protection; Proposal by the International Chamber of Commerce	Part two II, F
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A/CN.9/WG.II/XXXX/CRP.1 and Add.1-6	Draft report of the Working Group on Arbitration and Conciliation on the work of its fortieth session	Not reproduced
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## V. LIST OF DOCUMENTS OF THE UNITED NATIONS COMMISSION ON INTERNATIONAL TRADE LAW REPRODUCED IN PREVIOUS VOLUMES OF THE *YEARBOOK*

The present list indicates the particular volume, year, part, chapter and page where documents relating to the work of the United Nations Commission on International Trade Law were reproduced in previous volumes of the *Yearbook*; documents that do not appear in the list here were not reproduced in the *Yearbook*. The documents are divided into the following categories:

1. Reports on the annual sessions of the Commission
2. Resolutions of the General Assembly
3. Reports of the Sixth Committee
4. Extracts from the reports of the Trade and Development Board, United Nations Conference on Trade and Development
5. Documents submitted to the Commission (including reports of the meetings of Working Groups)
6. Documents submitted to the Working Groups:
  - (a) Working Group I:  
Time-Limits and Limitation (Prescription),(1969 to1974); Privately Financed Infrastructure Projects (since 2001)
  - (b) Working Group II:  
International Sale of Goods (1968 to 1977); International Contract Practices (1979-2000); International Commercial Arbitration (since 2000)
  - (c) Working Group III:  
International Legislation on Shipping (1968 to 1978); Transport Law (since 2002)\*\*
  - (d) Working Group IV:  
International Negotiable Instruments (1974-1987); International Payments (1988-1992); Electronic Data Interchange (1993-1996); Electronic Commerce (since 1997)
  - (e) Working Group V:  
New International Economic Order (1981-1994); Cross-Border Insolvency (1995-1997); Insolvency Law (since 1999)\*
  - (f) Working Group VI:  
Security Interests (since 2002)\*\*
7. Summary records of discussions in the Commission
8. Texts adopted by Conferences of Plenipotentiaries
9. Bibliographies of writings relating to the work of the Commission.

\* For its twenty-third session (Vienna, 11-22 December 2000), this Working Group was named Working Group on International Contract Practices (see the report of the Commission on its thirty-third session A/55/17, para.186).

\*\*At its 35<sup>th</sup> session, the Commission adopted one-week sessions, creating six of the three active working groups.

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A/8717 (fifth session)	Volume III: 1972	Part one, II, A	9
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A/9617 (seventh session)	Volume V: 1974	Part one, II, A	13
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A/39/17 (seventeenth session)	Volume XV: 1984	Part one, A	3
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A/42/17 (twentieth session)	Volume XVIII: 1987	Part one, A	3
A/43/17 (twenty-first session)	Volume XIX: 1988	Part one, A	3
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