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Draft legislative guide on insolvency law

Note by the Secretariat

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

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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.[1]

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;

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[1] See Part Two, Chapter III.B.8.

(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.][2]

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 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.[3]

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[2] See A/CN.9/530, para. 33 for the decision of the Working Group at its twenty-eighth session.
[3] The reference to a "contract" in this section includes the possibility of one or more contracts.

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 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.[4]

(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[5] and transfers to settle financial contract obligations,[6] should be exempt from avoidance under applicable avoidance provisions of the insolvency law [without prejudice to the rules on fraudulent transactions].

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[4] 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.

[5] 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.

[6] 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.

(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.[7]

(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.

[7] Even if a given financial contract does not involve a financial institution, the impact of the insolvency of a counterparty could entail systemic risk.