Insolvency close-out netting: A comparative study of English, French and US laws in a global perspective

Muscat, B.

Author: Muscat, B.

Title: Insolvency Close-out Netting: A comparative study of English, French and US laws in a global perspective

Issue Date: 2020-12-01

2 Introduction to Insolvency and Close-out Netting

2.1 Close-out Netting and its Treatment under Insolvency Law

Whilst the enforceability of close-out netting provisions on the basis of the principle of contractual freedom may be relatively unproblematic when enforced against a solvent defaulting party, the situation may be different if the defaulting party is insolvent.[1] Insolvency law is, to a considerable extent, mandatory law reflecting public policy.[2] Insolvency law plays an important role in the organisation of the affairs of a failing business. In its basic form, insolvency law provides for collective and compulsory proceedings on behalf of an insolvent debtor's creditors (most importantly its unsecured creditors), under which each creditor's individual rights and remedies for collection and enforcement are replaced by a procedure that applies for the benefit of the whole body of creditors and establishes a priority system, resulting in either the liquidation and distribution of the debtor's assets among its creditors or the reorganisation of the debtor's affairs, achieved through a rearrangement of its affairs with its creditors.[3]

It is arguably the case that the enforcement of close-out netting provisions will in most jurisdictions clash with some of the fundamental rules of insolvency law which traditionally seek to preserve the assets of the insolvent party for the benefit of its stakeholders.[4] These rules include, amongst others, the equal treatment of equally ranked creditors (the so-called '*pari passu* principle'), the coordinated management and enhancement of the insolvency estate and the preservation of assets of the insolvent estate in the interests of creditors.[5] In a number of jurisdictions this has led to the adoption of derogations or carve-outs from the provisions of national insolvency laws to ensure the enforceability of close-out netting arrangements 'in

1 UNIDROIT 2011 Close-out Netting Report, 14. For a discussion on the different groupings of national insolvency regimes, see WESSELS (2012) 383.

2 In this respect Wessels states that provisions of insolvency or bankruptcy law cannot usually be set aside by means of a choice of law provision in a netting agreement. See WESSELS (1997) 189.

3 In addition to these two goals of insolvency law (*i.e.* distribution and reorganisation), some academic writers indicate a third goal which relates to the provision of a mechanism by which the causes of failure can be identified and those guilty of mismanagement brought to justice. See VAN ZWIETEN (2018) 74; FINCH & MILMAN (2017) 15.

4 This will especially be the case in insolvency liquidations since in restructuring the basis for negotiating will be formed by principles of contract law.

5 See McKNIGHT (1996, updatable), para 38; PEETERS (2014) 66.

accordance with their terms' as governed by the *lex contractus* in the event of the insolvency of one of the parties.

It is the scope of this chapter to focus on the relationship between close-out netting and the application of national insolvency law, including bank resolution measures. This is intended to provide a theoretical background to the issues which will be taken into consideration in Parts II and III of this research where answers will be provided to the second and third sub-questions referred to in the Introduction, namely on the possible influence exerted by national insolvency and bank resolution laws on the recognition given to close-out netting provisions under the laws of the three selected jurisdictions. This is achieved by first giving an overview of some derogations granted to protect close-out netting provisions from the application of national insolvency law. This overview will be based on the UNIDROIT Principles which is considered a landmark document in the development of the close-out netting mechanism. This is followed by an analysis of the resurgence of bank resolution laws which, as will be seen in the national law chapters, have introduced restrictions in the freedom of the parties to apply their close-out netting provisions.

2.1.1 Derogations from Insolvency Law Principles

Wessels mentions a number of insolvency law principles which commonly feature in national insolvency law regimes.[6] A number of these principles which require a carve-out for close-out netting provisions to be effective are indicated in this chapter. The first derogation relates to the prohibition of termination of transactions and of pursuing individual creditor claims, known as the 'stay'. The stay is designed to control the loss of value of the insolvent estate by stopping the dismantling of the insolvent estate through private creditor action and the creation of new claims in order to rescue the business or otherwise to liquidate it.[7] Principle 7(1)(a) of the UNIDROIT Principles provides that 'the law of the implementing State should ensure that upon the commencement of an insolvency proceeding or in the context of a resolution regime in relation to a party to a close-out netting provision: (a) the operation of the close-out netting provision is not stayed'. The scope of this derogation is to ensure that in the exercise of early termination of a financial contract, a netting creditor is not fettered by the 'stay' or other

6 WESSELS (2012) 385.

7 In terms of the World Bank Principles for Effective Creditor Rights and Insolvency Systems, the rationale for the stay is that attempts at rescuing a business may fail unless the essential assets and component parts of the property of the debtor and its businesses are maintained. This policy supporting rescue necessitates that an injunction or stay of creditor actions be imposed for a reasonable period to prevent creditors from disassembling the business while the parties negotiate a rescue plan. On the other hand, in case of liquidation the stay aims to maximise the value of the debtor's estate so that creditors can be paid from the proceeds of the sale of the debtor's assets. See WORLD BANK Principles (2001), para 136 & 137.

national law restriction on termination rights that may automatically result from the commencement of insolvency proceedings or be imposed by the insolvency administrator or the insolvency court.[8]

Second, the stay may in certain jurisdictions also be intended to give the opportunity to the insolvency administrator to repudiate unfavourable contracts and to insist on performance of favourable contracts for the benefit of the insolvent estate. This is normally referred to as 'cherry-picking' whereby the insolvency administrator may decide to continue any transaction which is favourable for the insolvent party, whilst repudiating any unfavourable transactions, thus enabling the insolvency administrator to ensure the fullest possible preservation of the value of the insolvent estate. In relation to 'cherry-picking' powers, Principle 7(1)(b) of the UNIDROIT Principles provides that:

> 'the insolvency administrator, court or resolution authority should not be allowed to demand from the other party performance of any of the obligations covered by the close-out netting provision while rejecting the performance of any obligation owed to the other party that is covered by the close-out netting provision.'

Without an exemption from the exercise of such powers, the netting creditor would be faced with the 'unbundling' of the various obligations concluded under a single netting agreement and the impossibility to determine a global close-out netting amount.[9]

The third derogation is from avoidance provisions. Principle 7(1)(c) and (d) of the UNIDROIT Principles provide that:

> 'the mere entering into and operation of the close-out netting provision as such should not constitute grounds for the avoidance of the close-out netting provision on the basis that it is deemed inconsistent with the principle of equal treatment of creditors',

and

> 'the operation of the close-out netting provision, and the inclusion of any obligation in the calculation of the single net obligation under the close-out netting provision, should not be restricted merely because the close-out netting provision was entered into, an obligation covered by the provision arose or the single net obligation under the close-out netting provision became due and payable during a prescribed period before, or on the day of but before, the commencement of the proceeding.'

8 UNIDROIT 2013 Close-out Netting Principles, Principle 7(1)(a), 46.

9 PEETERS (2014) 68. The case may arise that one or some of the obligations or contracts covered by the close-out netting provision may, for any reason at law, be invalid or unenforceable. According to the UNIDROIT Principles the solution in this case is for the invalid obligation or contract to be severed from the rest of the bundle to ensure that it does not affect the validity of the other obligations or contracts. See UNIDROIT 2013 Close-out Netting Principles, 55.

Acts of the netting creditor are typically exempted from any power of the insolvency administrator or the insolvency court which may exist under national law to set aside or avoid payments or other transfers that have been made during a co-called 'suspect period', which is a period either fixed by statute or otherwise defined, for instance, by the insolvency court prior to insolvency usually on the basis that this would give an unjustified preference to some creditors over others or give rise to unjustified deprivation of the insolvency estate of relevant assets.[10] The same applies to any 'zero-hour rules', namely rules that bring forward the commencement of insolvency proceedings to 0:00 hours of the day of the decision to open insolvency proceedings.[11] In this regard, the carve-out would ensure that the enforceability of the close-out netting provision would not be impaired by the application of the zero-hour rule. These avoidance powers would otherwise frustrate the possibility of affecting early termination under a close-out netting provision, in particular since it is the commencement of the insolvency proceedings itself that triggers the close-out netting mechanism.

These three derogations or carve-outs (*i.e.* the stay, cherry-picking and avoidance) should not continue to safeguard the enforceability of close-out netting provisions where there is fraudulent intent. This is reiterated in Principle 7(2) of the UNIDROIT Principles which provides that the proposed carve-outs from the rules of insolvency law should:

> 'not affect a partial or total restriction of the operation of a close-out netting provision under the insolvency law of the implementing State on grounds which include factors [...] such as the knowledge of a pending insolvency proceeding at the time the close-out netting provision was entered into or the obligation arose, the ranking of categories of claims, or the avoidance of a transaction as a fraud of creditors.'[12]

---

10 *Ibid.* 69. According to the World Bank's Principles on Effective Creditor Rights and Insolvency Systems, transfers covered by the avoidance principles normally fall into two categories: fraudulent and preferential. Fraudulent transfers are those made in collusion with the debtor with an intent to defraud creditors, while preferences are typically payments made in the usual course of affairs but which violate the *pari passu* principle by preferring some creditors over others who may remain unpaid during the period of insolvency leading up to the filing of insolvency. See WORLD BANK Principles (2001), para 126. In those jurisdictions where action taken upon insolvency is regarded as suspicious or may be impugned, parties to a close-out netting agreement have devised the concept of automatic early termination in terms of which all transactions are deemed to have been automatically terminated and netted or set off immediately prior to the occurrence of the relevant insolvency event, with the intention that they are taken outside of the restrictions related to the moment of insolvency. Annetts and Murray are of the opinion that this technique of automatic early termination is to be used only where necessary. They opine that purely contractual solutions of this kind to insolvency law problems are of dubious efficacy in the face of public policy arguments. See ANNETTS & MURRAY (2012) 281.

11 UNIDROIT 2013 Close-out Netting Principles, 61.

12 *Ibid.* 47.

The aforementioned derogations effectively result in the non-enforceability of the *pari passu* principle in relation to the exercise of close-out netting rights. Under this principle all unsecured creditors share proportionally in the assets of the insolvent estate that are available for residual distribution, meaning that these creditors are paid *pro rata* to the extent of their pre-insolvency claims and, depending on national law, in conformity with the class of claims to which they belong. The *pari passu* principle applies only to the unencumbered assets of the insolvent estate that are available for distribution. Thus, where the insolvent debtor has given security rights over its assets, these assets are available for distribution only to the extent that the value of those assets exceeds the amount of the secured credit.[13]

Prior to insolvency creditors are free to pursue whatever enforcement measures are available to them, subject to any applicable *moratoria* or cooling off periods. As a general rule, insolvency puts an end to this private individual action to enable the appointed insolvency administrator or practitioner to pursue the orderly administration of the insolvent estate and the liquidation of the assets, and to distribute *pari passu* the net proceeds derived from the sale of assets of the insolvent estate. The rationale of the *pari passu* principle is that within a mandatory, collective regime it facilitates a transparent and orderly procedure of dealing with unsecured creditor claims. The *pari passu* principle is also said to bring a measure of fairness in the insolvency proceedings since it aims to ensure equality of treatment between unsecured creditors. Its effect is to invalidate agreements, payments and transfers which could give unfair preference to a particular creditor by removal from the insolvent estate of an asset that would otherwise have been available for the general body of creditors.[14]

In cases where national insolvency law allows prior private arrangements such as close-out netting provisions to be enforceable upon insolvency, such arrangements are enforced against the insolvent debtor thus bypassing the *pari passu* principle. The effect of insolvency close-out netting is that upon the occurrence of insolvency the parties reduce their mutual obligations to one single balance of indebtedness. This implies that the netting creditor may apply what is due by the insolvent debtor from its own dues, thus ensuring payment of its claim *pro tanto* ahead of other creditors. One policy justification for allowing close-out netting is that each party engaged in mutual dealings extended credit in reliance on the ability to enforce the close-out provision. Nonetheless, jurisdictions may impose limitations on the extent to which private arrangements can supersede the

13 FINCH & MILMAN (2017) 511.

14 VAN ZWIETEN (2018) 304. Writing in the context of English law, van Zwieten clarifies that, unlike the provisions on preferences that are intended to unwind payments and transfers already made to a creditor on the eve of the opening of insolvency proceedings, the *pari passu* rule does not have retroactive effect. But it could lead to the annulment of agreements designed to give one creditor a benefit at the expense of the others upon insolvency. *Ibid.*

application of the *pari passu* principle.[15] A typical example relates to the creditor's knowledge of the impending insolvency of the debtor at the time of entering into the close-out netting agreement.[16]

2.2 Credit Institutions, Resolution Measures and Financial Stability

The insolvency and resolution of credit institutions are in some jurisdictions subject to general insolvency laws whereby ordinary insolvency principles generally apply to credit institutions, while in other jurisdictions credit institutions are subject to special insolvency regimes administered by competent administrative authorities.[17] In terms of the World Bank 2001 Principles and Guidelines for Effective Insolvency and Creditors Rights Systems credit institutions are different from other market participants because a safe and sound banking system is indispensable for sustainable economic growth. Moreover, credit institutions are vulnerable to destructive panics caused by a sudden loss of public confidence which would lead to so-called 'bank runs' whereby depositors rush to withdraw their deposits from a distressed credit institution.[18] Another reason given by the World Bank for the special treatment of credit institutions is related to the interconnectedness of these institutions with other domestic and international financial institutions whereby the inability of one sufficiently interconnected credit institution to honour its obligations could affect the health of other financial institutions resulting in a systemic crisis both within and across borders.[19] It is therefore considered to be necessary that the prudential regulation and resolution of credit institutions are driven by financial stability considerations.[20]

It has been stated that this shift in the purpose of insolvency law in relation to credit institutions puts pressure on the relationship between bank insolvency law and general insolvency law. For instance, normal insolvency law remains directed at liquidation of the insolvent business and the maxi-

15 PAECH (2014) 440.

16 This is for instance the case under Article 8(2) of the EU Financial Collateral Directive.

17 LASTRA (2015) 165. For an overview of the shortcomings of general insolvency proceedings in relation to bank failures, see Stephan Madaus, 'Bank Failure and Pre-Emptive Planning', in HAENTJENS & WESSELS (2014) 52.

18 WORLD BANK Principles (2001), Annex I, para 2. According to the World Bank, this loss of confidence in financial soundness mainly stems from the traditional role of credit institutions in intermediating between short-term demand deposits and medium- and long-term loans with the result that a distressed credit institution may not be able to meet demands for deposit withdrawals, thereby becoming illiquid. *Ibid.* para 4.

19 *Ibid.*

20 In a 2009 report which updates the concerns expressed in the World Bank 2001 report in relation to the failure of banks, the IMF and the World Bank sum up these financial stability considerations to refer to the smooth functioning of payment and settlement systems, the protection of the depositing public, and the preservation of the credit intermediation function. See IMF and World Bank 2009 Bank Insolvency Report, 16.

misation of credit value, whereas bank insolvency law is directed at both the preservation of certain assets and functions, such as insured deposits and critical services, and the controlled liquidation of all other assets of the credit institution.[21]

One notable difference between the two regimes is that the restructuring or resolution of credit institutions is a broader concept than rehabilitation under general insolvency law, both in terms of function and timeliness.[22] Corporate rehabilitation under general insolvency law typically commences only if the corporate debtor is declared insolvent in statutory terms. By contrast, the restructuring of credit institutions is usually a consequence of the regulatory enforcement of prudential supervision which may be exercised when a credit institution fails to meet statutory solvency levels. Bank restructuring may thus begin at an earlier stage than corporate rehabilitation.[23] As will be seen in more detail in the national law chapters, the special treatment of bank restructuring has important consequences for the legal rights of creditors (and, it may be added, its shareholders). In general insolvency proceedings, such rights are protected, and at times even preferred, by procedural safeguards and by judicial administration of rehabilitation and liquidation proceedings. However, fewer or different safeguards may be available in bank restructuring which is typically under the control of an administrative authority subject to principles of administrative law intended primarily to allow for more timely solutions. In its report on the Resolution of Cross-Border Banks, the IMF expresses the situation as follows:

21 HAENTJENS (2014a) 72. Haentjens notes two consequences of this pressure in the relationship between general insolvency law and bank resolution law. From a theoretical perspective, it may endanger the coherence of relevant national systems of law which can thus affect the efficiency, transparency and rationality of a legal system. Thus, any incoherence between bank resolution rules and insolvency law may undermine the equality, legal certainty and rationality of a legal system. From a practical perspective, as a matter of legal interpretation, bank resolution rules will be deemed to be embedded in the general insolvency regime and hence the latter regime will remain applicable in the case of a *lacuna* in the specific bank resolution rules. *Ibid.* 73.

22 To this may be added that on account of the serious consequences of bank failure, there is a bias in favour of saving failing banks. This may also be due to the fact that states place a high value on the uninterrupted operations of credit institutions and accessibility of depositors' savings. Thus, there is typically active participation by a state or state authorities in the restructuring of insolvent banks in situations where their financial and operational condition might, under general insolvency principles, point to their closure and liquidation. This is particularly the case in relation to large banks which are deemed 'too big to fail'. See MAYES & LIUKSILA (2004) 281.

23 WORLD BANK Principles (2001), Annex I, para 8, p 64. According to Lastra, the term 'resolution' has become a term of art in the aftermath of the financial crisis. Lastra states that bank resolution is at the end of the spectrum of the supervisory process when there is already crisis management but before actual insolvency. Resolution is therefore considered as part of the 'pre-insolvency phase' for failing credit institutions though there are instances where resolution also encompasses actual insolvency. See LASTRA (2015) 166.

> 'Resolution powers overrule ordinary private property and contractual rights in the interests of wider public interests such as financial stability. Accordingly, countries which adopt such resolution powers need to have strong safeguard mechanisms which ensure that powers are exercised appropriately. The effectiveness of international resolution action depends on all the involved countries having minimum safeguard protections that would be available to all creditors of the affected entity irrespective of nationality. These safeguards would *inter alia* ensure that […] netting and financial collateral arrangements are respected (subject potentially to the temporary suspension of close out netting rights in respect of financial contracts transferred to a solvent third party) […]'[24]

Credit institutions and certain investment firms have been singled out for special treatment in case of failure or pending failure. This has implied, *inter alia*, that the exercise of contractual termination rights has been affected by a temporary stay, though all safeguards should normally remain in place. Such resolution regimes have been put in place in some jurisdictions in recognition of the fact that financial stability considerations should be given due precedence over party autonomy relating to the exercise of termination rights. The question arises whether future developments will extend the category of institutions which will be similarly regulated in case of distress and whether the restrictions on party autonomy will extend beyond the temporary stay on termination rights that is currently being implemented in a number of jurisdictions. This will bring the relationship between contractual close-out netting rights and insolvency laws in the financial markets under more scrutiny and may lead to further re-consideration of the recognition granted to close-out netting provisions in the face of a pending failure of a market participant.

2.3 Preliminary Conclusions

It is the aim of this chapter to provide a preliminary understanding of the type of issues or obstacles that may be encountered by counterparties in the recognition given to their close-out netting provisions in the light of their national insolvency and bank resolution regimes. For this reason, the recognition of close-out netting provisions requires in most jurisdictions statutory intervention to ensure that parties can rely on their contractual rights and it is to be expected that the type of derogations granted, or the restrictions introduced, by legislators in view of their insolvency and bank resolution regimes may vary from one jurisdiction to another.

It has been seen that, from a conceptual point of view, the recognition of a close-out netting provision requires a number of important derogations or carve-outs from national insolvency law principles. The UNIDROIT Principles make a number of proposals related to the recognition of close-out

24 IMF 2010 Resolution of Cross-Border Banks, Box 7 at 22.

netting provisions which ensure that (i) the operation of close-out netting provisions are not stayed upon the commencement of an insolvency or resolution proceeding, (ii) the court or insolvency practitioner is not allowed to exercise cherry-picking powers in relation to obligations covered by a close-out netting provision, and (iii) the operation of a close-out netting provision during a suspect period does not constitute a ground for avoidance on the basis that it is deemed detrimental to the equal treatment of creditors. The enforceability of insolvency close-out netting is considered an important derogation from the *pari passu* principle as it directly affects the amount of assets of the insolvent estate which are available for liquidation and proportional distribution among unsecured creditors.

A lesson learnt from the recent financial crisis is that the private termination of contractual obligations may prevent regulatory authorities from taking resolution measures to resolve the financial difficulties faced by a systemically important market participant. For this reason, it will be seen in the next chapter that post-crisis statements issued by international entities such as the BIS and the FSB recommend the introduction of legislative powers allowing national authorities to delay the private exercise of termination rights in order to permit the transfer of financial contracts of an institution under resolution to a solvent institution.

This realisation triggers the question of when the private right of closing out should give way to the public policy objectives sought to be achieved by national insolvency law. From a traditional perspective, national insolvency law seeks to lay down rules to protect the value of the insolvent estate to ensure maximisation of assets for distribution among the insolvent debtor's creditors. With the surging importance of financial stability as a goal to be pursued by the State, there is nowadays a trend for insolvency regulation of certain financial market participants, such as credit institutions or investment firms which are either too highly interconnected or which perform critical services in society, to take into consideration new interests such as the general interest of the public or postulate a different way of looking at systemic risk. This has resulted in a reconsideration of the extent of recognition hitherto granted to close-out netting provisions with the result that we now see the introduction of limited restrictions, such as the imposition of a temporary stay, on the exercise of private termination rights to allow for the orderly resolution of these entities. The influences of the national insolvency law and the national bank resolution regime on the development of close-out netting will be viewed in Part II in the light of English, French and US laws.