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

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Title: Insolvency Close-out Netting: A comparative study of English, French and US laws in a global perspective
Issue Date: 2020-12-01

6 Insolvency Close-Out netting under US Law

6.1 Overview of the Regulation of Insolvency Close-out Netting under US Law

The US legal system has been described in the Introduction as an eclectic system which was historically influenced by both the common and civil law regimes. Based solely on considerations of its legal heritage, it is expected that the US regime will not be as liberal and pro-creditor as the English regime in the safeguarding of pre-insolvency contractual entitlements. On the other hand, it may well not be as restrictive as French law with its pro-debtor tendency instituted by the Code Napoleon and stricter approach on pre-insolvency contractual claims. It is presumed that as a hybrid system US law will adopt a more balanced approach towards the recognition given to close-out netting provisions.

In reality, the application of US law is not as straightforward as in the case of the other two national law systems analysed in this research. This is because US law is based on the dual application of federal and state laws so that areas of law such as insolvency proceedings, insolvency set-off and insolvency close-out netting may be regulated by two complementary regimes. As a result, this may distort the expectation that US law is reflective of a hybrid system when compared to the English and French systems given that the recognition of contractual rights may, to a greater or lesser extent, depend on the particular applicable state law and its common or civil law origin.

It is not intended in this chapter to analyse insolvency close-out netting under the various state laws, unless this is by way of example to illustrate an argument being made. The focus will be on US federal law and on the approach adopted by the legislator under US federal law when dealing with the recognition of party autonomy. The reason for this is that federal law sets mandatory rules having nationwide effect. Indeed, state laws apply to the extent that mandatory federal rules do not provide otherwise. Thus, whilst contractual rights are at first instance established and regulated by state law, federal law may impose restrictions or conditions on the exercise of those rights recognised by state law. This is certainly the case in relation to insolvency law and insolvency proceedings where, as will be seen below, rights recognised under state law are applicable within the confines set by federal law. Consistent with the previous two national law chapters, a brief overview is made initially of the interaction of US federal insolvency rules and applicable resolution regimes with the recognition of close-out netting provisions.

Insolvency Rules

In the US the term 'bankruptcy', rather than insolvency, is used to refer to formal insolvency proceedings. There are two main avenues under US law for addressing the situation of a bankrupt debtor. It may be reorganised or liquidated under the Federal Bankruptcy Code[1] (the Bankruptcy Code or the Code) or, where applicable, resolved under one of the special resolution regimes reserved for handling the insolvency of regulated financial entities such as insured depository institutions (*i.e.* banks) and systemically important non-bank financial institutions.[2] The Bankruptcy Code has been generally described as 'pro-debtor, with some exceptions'.[3] Chapter 11 of the Bankruptcy Code regulates reorganisation proceedings concerning corporations, sole traders or partnerships.[4] Under this proceeding, the debtor, acting under the supervision of a federal bankruptcy judge, may negotiate with its creditors a plan of reorganisation that allows for the restructuring of the debtor's liabilities.[5] Chapter 7 of the Bankruptcy Code, on the other hand, regulates liquidation proceedings.[6] Under this proceeding, the debtor's assets are typically liquidated by a trustee and the proceeds of the liquidation are distributed among the debtor's creditors, depending on the priority of their claims.[7] The debtor generally chooses whether the case is to be a Chapter 11 reorganisation or a Chapter 7 liquidation. A novel aspect of US insolvency law, when compared with English and French laws, is that upon filing a petition for reorganisation under Chapter 11, the debtor, sometimes identified as the debtor-in-possession (DIP), retains possession and control of its assets while undergoing a reorganisation.[8]

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1 Title 11 of the United States Code (11 U.S.C.).

2 For a generic comparison of the features of these regimes, see Bliss & Kaufman (2011) 349.

3 BERGMAN *et al.* (2004) 13. For an analysis of the historical origins of the debtor-friendly approach of US bankruptcy law, see HANSEN & ESCHELBACH HANSEN (2007) 203.

4 11 U.S.C. §§ 1101 to 1174. Chapter 11 proceedings may be instituted by filing with the bankruptcy court either a voluntary petition filed by the debtor or an involuntary petition filed by creditors that meet certain requirements. See 11 U.S.C. §§ 301 & 303. Certain entities such as banks, savings and loans associations, insurance companies and a number of other statutorily defined financial entities are specifically excluded from becoming debtors under the Bankruptcy Code. See 11 U.S.C. § 109(b)(2). Such entities are subject to their own particularized insolvency regimes, including the FDIA in the case of federally chartered banks and savings and loan associations, and state laws in the case of insurance companies. Insolvent brokers and dealers are liquidated pursuant to the Securities Investor Protection Act (SIPA), although stockbrokers may also be liquidated under the Bankruptcy Code. See 11 U.S.C. §§ 741 *et seq*.

5 11 U.S.C. § 109.

6 11 U.S.C. §§ 701 to 784.

7 These priorities are set out in 11 U.S.C. § 507 and 726. See in this respect LUBBEN (2016) 581. Lubben describes in generic terms the basic order of payment as follows: '[…] secured creditors get paid first, unsecured creditors get paid next, and only then do shareholders get paid, if at all.' *Ibid.* The FDIA also provides a list of priority payments in 12 U.S.C. § 1821(d)(11)(A). See in this respect, BLISS & KAUFMAN (2006a) 15.

8 11 U.S.C. § 1101.

According to Skeel and Jackson, bankruptcy law's 'heart and soul' lie mainly in two principles, namely the automatic stay and the bankruptcy trustee's power to avoid preferential transfers.[9] The automatic stay is considered key to bankruptcy's collective proceeding since it prohibits creditors from taking enforcement action, thereby preventing a 'grab race'.[10] The second principle is the preference provision which, with various exceptions, empowers the debtor or, if one is appointed, the bankruptcy trustee to retrieve payments or other transfers made to a creditor within ninety days of bankruptcy.[11] A third equally important principle is the ability of debtors to 'assume or terminate' executory contracts,[12] which allows a debtor to cherry-pick which executory contracts to assume and which to terminate.

Two special resolution proceedings apply in relation to specified financial institutions. Under the first resolution regime, insured depository institutions are subject to the resolution proceedings of the Federal Deposit Insurance Act (FDIA). The FDIA empowers the Federal Deposit Insurance Corporation (FDIC) to act as receiver or conservator of the insured institution.[13] As receiver, the FDIC has the power to liquidate and wind up the affairs of an insured institution, while as conservator, the FDIC has the power to continue operating the insolvent insured institution. The goal of this regime is to resolve the financial distress of a failed bank in the manner that is least costly to the FDIC's deposit insurance fund,[14] unless the resolution is deemed necessary for systemic reasons.[15] The FDIC has several options as receiver for resolving institution failures, such as the transfer of all or some of the institution's assets and liabilities to a bridge institution owned and operated by the FDIC which would then enable the resolution of the closed institution.[16] The second resolution regime was introduced by Title II of the Dodd-Frank Act. This regime established the Orderly Liquidation Authority (OLA) which authorises the Secretary of the Treasury to appoint the FDIC as receiver of certain systemically significant

9 11 U.S.C. §§ 362(a) & 547, respectively. See SKEEL & JACKSON (2011) 158.

10 See also 11 U.S.C. § 365(e) which nullifies *ipso facto* contractual clauses such as clauses specifying that a bankruptcy filing will result in an automatic default and a termination payment.

11 11 U.S.C. § 547(b)(4).

12 11 U.S.C. § 365(a). Executory contracts under US law are those contracts which remain materially uncompleted by both parties, and thus have elements of both assets and liabilities. For a discussion of the types of contract under US law, see SKEEL & JACKSON (2012) 169.

13 See 12 U.S.C. § 1811 *et seq*. The FDIC is a US government corporation providing deposit insurance to depositors in US banks. See the FDIC website at <https://www.fdic.gov/>. To note that if an insured institution is a national banking association, it is also subject to certain provisions of the National Bank Act (12 U.S.C. 38).

14 12 U.S.C. § 1823(c)(4)(A)(ii).

15 12 U.S.C. § 1823(c)(4)(G).

16 12 U.S.C. §§ 1821(c)(13)(G)(II) & (n)(1)(B)(i)(ii). See in this respect BLISS & KAUFMAN (2006a) 9.

financial companies that are not federally-insured depositories.[17] The OLA regime applies to US bank holding companies, any companies mostly engaged in financial activities and any subsidiaries of such companies that are mostly engaged in financial activities (referred to as a 'covered financial company').[18] The purpose of the OLA regime is 'to provide the necessary authority to liquidate failing companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.'[19] The FDIC must determine that any action taken under the OLA regime is necessary for purposes of the financial stability of the US, rather than for the purposes of preserving the covered financial company, and must ensure that unsecured creditors bear losses in accordance with the priority of claims provisions of the OLA regime.[20]

The US 'Safe Harbours'

The regulation and recognition of close-out netting under US law is regulated by various laws, namely the Bankruptcy Code, FDIA, the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and Dodd-Frank. Although these laws broadly regulate close-out netting provisions of financial contracts entered into between financial institutions, the exact scope of application varies from one law to another. The safe harbours are based on a three-pillar structure since they seek to protect the contractual rights of stipulated parties to particular financial contracts from the application of the Bankruptcy Code. Contractual rights typically include the ability to terminate and set-off or net payment and delivery obligations. The covered contracts include securities contracts, commodities contracts, repurchase agreements, forward contracts, swap agreements and master netting agreements in relation to these contracts. Protected parties generally comprise commodity brokers, forward contract merchants, stockbrokers, financial institutions, securities clearing agencies, repo participants and swap participants.[21]

17 12 U.S.C. §§ 5381-5394.
18 12 U.S.C. § 1841(a).
19 12 U.S.C. § 5384.
20 12 U.S.C. § 5386. In addition to these regulatory laws, the US prudential regulators have adopted regulations requiring systemically important financial institutions and certain subsidiaries to include contractual provisions in their financial contracts to ensure that counterparties opt in to the temporary suspension of termination rights of FDIA and OLA and to prevent counterparties from exercising default rights related to the entry into resolution of an affiliate of the financial institution. The regulations provide a safe harbor for contracts amended pursuant to the ISDA 2015 Universal Resolution Stay Protocol or similar protocol. See 12 C.F.R. §§ 252.83-84; 12 C.F.R. §§ 382.3-4; 12 C.F.R. §§ 47.4-5.
21 See 11 U.S.C. §§ 362(b)(6), 555, 556, 559, 560 & 561.

Schwarcz and Sharon list three ways in which the safe harbours protect contractual rights.[22] Firstly, protected counterparties are permitted to exercise their contractual enforcement remedies against a debtor or its property, including through closing out, netting and setting off amounts owed reciprocally, and liquidating collateral in their possession, notwithstanding the automatic stay on individual creditor action.[23] Secondly, the safe harbours exempt protected counterparties from the exercise of trustee avoiding powers in relation to preference rules and constructively fraudulent transfers regarding any payment and collateral received prior to the bankruptcy unless the transferee had actual intent to hinder, delay or defraud the debtor, its creditors or any receiver or conservator of the debtor.[24] Thirdly, bankruptcy law allows protected counterparties to enforce *ipso facto* termination clauses, and to net all existing contracts with the debtor with the consequence that the latter may not exercise any assumption or rejection powers which would have entitled it to terminate unfavourable contracts and demand execution of favourable ones.

A distinction is made by Bliss and Kaufman between executory and non-executory contracts and the treatment of close-out netting under each type of contract. Executory contracts are stated to consist of 'promises to transact in the future (but where no transaction has yet occurred)' whilst non-executory contracts arise 'where a payment by one party has already occurred.'[25] They state that whilst non-executory contracts may be accelerated in insolvency if they contain clauses that permit the creditor to accelerate future payments upon the occurrence of a stipulated event of default, executory contracts are simply terminated, thereby creating a claim for compensation, which is typically the cost of replacing the contract on identical terms with another solvent counterparty.[26] This distinction will be borne in mind when considering the constitutive elements of insolvency close-out netting under US law.

6.2 Constitutive Elements of Insolvency Close-out Netting

The relevant Bankruptcy Code provisions on the US safe harbours are found in sections 555 relating to securities contracts, 556 relating to commodities contracts and forward contracts, 559 relating to repurchase agreements and 560 relating to swap agreements. Sections 555 and 556 were both originally promulgated in 1982 and protect the contractual rights to liquidate, termi-

22 SCHWARCZ & SHARON (2014) 1718. In this respect, see also MOONEY (2014) 250; ADAMS (2014) 99. For an overview of the historical development of derivatives safe harbours under US law, see FAUBUS (2012) 821.

23 11 U.S.C. §§ 362(b)(6), (7), (17) & (27); 553(b)(1); 555-556, & 559-562.

24 11 U.S.C. §§ 546(e) - (g) & (j), & 548(d)(2).

25 BLISS & KAUFMAN (2006) 58.

26 *Ibid.*

nate and accelerate protected contracts. Section 559 was promulgated in 1984 and refers in addition to set-off rights. It was only in 1990 that the first mention and specific protection of netting was made in relation to swap agreements under section 560, in addition to the protection of the other rights. Netting rights are also specifically protected in Section 561, added in 2005, which provides for cross-product netting across the range of protected contracts so that close-out and netting are possible across all protected contracts if exercised under a master netting agreement.[27]

It is proposed to focus the analysis of the constitutive elements of close-out netting on those provisions of US law which specifically refer to the exercise of the contractual rights of close-out and netting. First, a commentary is made of two definitions which may shed light on the notion of close-out netting, namely the definitions of 'master netting agreement' in section 101(38A) of the Code and of 'netting contract' in section 402(14) of FDICIA. This is followed by a consideration of what are arguably the two main provisions on close-out netting under US law, namely: (i) section 560 of the Bankruptcy Code which, together with section 561 dealing with contractual rights under master netting agreements, is the only safe harbour provision that refers specifically to the netting of payment amounts or termination values; and (ii) section 403 of FDICIA which protects the enforceability of close-out netting agreements 'in accordance with their terms'.

Section 101(38A) of the Bankruptcy Code provides a definition of 'master netting agreement', which is the term used in section 561 of the same Code to protect cross-product netting in relation to the financial contracts covered by the US safe harbours. From a conceptual point of view, the following points resulting from this definition are indicative of the constitutive elements of close-out netting:

(a) A master netting agreement is stated to provide for the exercise of rights, including rights of netting, set-off, liquidation, termination, acceleration or close-out. This list reflects the list of contractual rights protected in the context of a master netting agreement in terms of section 561 and gives the impression that close-out and netting are considered as two separate rights forming part of a longer list of other contractual rights covered by this definition. This understanding is also in conformity with the fact that originally only the termination, acceleration and liquidation were protected under the initial safe harbours, with netting and offset being added as additional protected rights in section 560 of the Bankruptcy Code.[28] This is also made evident by the apparent lack of order in the listing of rights so that the reference to netting, contrary to the order

27 MORRISON & RIEGEL (2015) 649.

28 The idea of close-out and netting being separate rights rather than forming a single close-out netting mechanism is confirmed by Bliss and Kaufman when they state that '[c]lose-out and netting consist of two separate but related rights, often combined into a single contract'. See BLISS & KAUFMAN (2006) 58.

of events, precedes that of termination, liquidation, acceleration and close-out. Set-off is also considered as a right to be protected in a master netting agreement, which already indicates the close affinity with the close-out netting concept since a master netting agreement, of its own nature, refers to the multiple netting of payment obligations. This definition includes all possible aspects of terminating a contract, including by both outright termination (*i.e.* for an executory contract) and acceleration (*i.e.* for a non-executory contract). It is not clear if the term 'liquidation' adds anything in substance to the list of contractual rights contained in the definition. In theory, liquidation may be assimilated with termination or acceleration, or it may otherwise refer to the whole process of terminating or accelerating, calculating a close-out or set-off amount and proceeding to the actual set-off or netting so that liquidation is the end-result of this whole process. In this latter case, liquidation would also incorporate the various steps that constitute close-out netting as a single mechanism.

(b) Being a definition of a master netting agreement, its scope is limited to the netting of obligations arising out of the financial contracts covered by the safe harbours and listed in section 561(a) of the Bankruptcy Code. The scope is extended to any security or credit enhancement arrangement supporting the contracts. As a result, in establishing the close-out amount, the counterparties may also take into account in the calculation methodology any collateral arrangement entered into.[29] This indicates that the exercise of contractual rights relating to close-out and netting is protected irrespective of whether the close-out netting provision forms part of a financial collateral arrangement or not, as long as the financial contract falls within the list of protected agreements.

The second definition is that of 'netting contract' under section 402(14)(A)(i) of FDICIA. The definition applies in relation to sections 403 on bilateral netting and 404 on clearing organisation netting. Although it may not be considered as an exhaustive definition insofar as concerns the elements of close-out netting, this is a particularly interesting definition since it is related to the 'blanket' recognition of close-out netting provisions under section 403 of FDICIA which is analysed below. The following elements may be identified from this definition:

(a) The netting contract is envisaged to be between '2 or more financial institutions, clearing organisations or members.' The words '2 or more' financial institutions refers to the fact that this definition applies in relation to both bilateral netting contracts where netting is bilateral as well as to clearing organisation netting relating to a multi-party clearing or

29 See in this respect, BERGMAN *et al.* (2004) 20; JANGER *et al.* (2014) 3.

payment system.[30] The issue of multilateral netting and the need to have mutuality for close-out netting to be effective will be analysed later in this chapter.

(b) The netting envisaged under this definition is the netting of 'present or future payment obligations or payment entitlements.' This captures the netting of contractual rights emanating from both executory contacts resulting in the termination of present obligations as well as non-executory contracts leading to the acceleration of future obligations. This definition seems to be restricted to the netting of payment obligations and does not mention the netting of delivery obligations nor the taking into account of credit enhancement arrangements. However, this does not necessarily mean that the latter two elements have been excluded from this definition since following the calculation of the monetary values of delivery and collateral obligations, this will in any case result in a payment obligation or a payment entitlement. Hence, a payment obligation may, in the end, comprise also delivery and collateral obligations.[31]

(c) A netting contract is also envisaged to include the 'liquidation or close-out of values relating to such obligations or entitlements.' This phrase appears to imply that liquidation and close-out are similar concepts which achieve the valuation of payment obligations. US law may thus give a more limited meaning to liquidation than envisaged in the first definition considered above so that it is more probably limited to 'liquidating' contractual obligations into monetary values than to incorporating other rights such as set-off or netting rights. Another aspect of this phrase is that US law recognises that the methodology of liquidation of values will be that established by a netting contract and hence to be determined by party autonomy.

Arguably, the most prominent safe harbour in relation to derivatives, and the only one specifically referring to close-out netting, is section 560 of the Bankruptcy Code dealing with the contractual right to liquidate, terminate or accelerate a swap agreement. Section 560 preserves the contractual right of a swap participant or financial participant, in view of the financial condition of the counterparty, to liquidate, terminate or accelerate one or more swap agreements and to offset or net out any termination or payment amounts under it. In conformity with the other safe harbours, a contractual right under section 560 is stated to include also a right contained in a rule or bylaw of certain industry associations or a right arising under common or merchant law or by reason of normal business practice, whether or not the

30 The bilateral nature of close-out netting was confirmed by the court *In re Lehman Brothers Inc,* 458 B.R.134, 142-3 (Bankr. S.D.N.Y. 2011) where the court held that netting could only happen on an entity-by-entity basis and rejected the argument that a corporate group could be treated as if it were a single firm.

31 See BLISS & KAUFMAN (2006) 60.

right is evidenced in writing. The following three elements on the regulation of close-out netting may be derived from the provision of section 560:

(a) The exercise of liquidation, termination or acceleration rights arising under a swap agreement is triggered by the occurrence of an event of the kind specified in section 365(e)(1) of the Code. These events relate to the insolvency or financial condition of the debtor, the commencement of a case under the Bankruptcy Code and the appointment of a trustee in a case under the Code or of a custodian before the commencement of a case.

(b) The exercise of contractual rights 'to offset or net out any termination values or payment amounts' arises in connection with the termination, liquidation or acceleration of one or more swap agreements. Three points may be noted in this respect. First, offset[32] and netting are recognised as two alternative modalities to determine a close-out amount. Second, this provision recognises that the termination values arise in connection with a swap agreement so that the modalities of calculation are also contractually set in the agreement and are determined by party autonomy. Third, the words 'arising out of or in connection with' indicate that the termination (or close-out) and netting, although separate rights, are related when arising out of a financial contract such as a swap agreement. In other words, the netting should be preceded by the termination of the transactions.

(c) Contractual rights appear to be fully respected in this provision since all references to the exercise of contractual rights and to valuation modalities are stated to arise from contractual arrangements. The fact that section 560 refers to the exercise of contractual rights deriving from rules or bylaws of industry associations does not affect the exercise of contractual rights because the reference only adds to the various possibilities for the origin of the contractual rights and does not detract from the possibility that rights arise also (and solely) from bilateral arrangements.

32 When used in this context, the term 'offset' is assumed to be equivalent to 'set-off'. This appears to be confirmed by Bliss and Kaufman who define offset similarly to set-off as 'the canceling of reciprocal obligations to arrive at a net amount owed or claimed'. See BLISS & KAUFMAN (2006a) 17. However, in an earlier paper, Bergman *et al.*, state that '[s]et-off, netting, and offset are conceptually equivalent, but their legal treatments are distinct.' According to these authors, whilst set-off refers to the netting of individual contracts where the payment amount is settled in due course with the settlement of other claims in the insolvency, the term offset applies to the individual netting and close out of qualified financial contracts in order to achieve a single close-out amount. See BERGMAN *et al.* (2004) 5. This is the approach adopted by the legislator in section 553 of the Bankruptcy Code which, although entitled 'Setoff', refers in section 553(a) to the 'right of a creditor to *offset* a mutual debt'. Therefore, offset is the more specific term to be used in relation to the set-off of protected financial contracts.

The scope of application of section 560 is considered quite extensive. It has been stated that the definition of a 'swap agreement' is so wide as to include effectively all derivative contracts.[33] The definition also includes a clause which extends the Code's protection to any transaction that is 'similar' to the one listed in the definition itself[34] and to any collateral and other credit enhancements. This definition is deemed to overlap with the other definitions of the Code.[35] Also in relation to swap agreements, any party may be protected, and not only financial parties. On account of this, Morrison and Riegel note that in relation to the definition of swap agreement, essentially 'all derivatives have become swap agreements, all parties to them and all transfers in relation to them benefit from the Code's protections' leading to comprehensive 'financial market protection' as opposed to the protection of particular parties and particular agreements as well as the elimination of the three-pillar construction on which the safe harbours were traditionally built.[36]

The US courts have limited the application of the section 560 safe harbour which protects rights triggered by *ipso facto* clauses. The court in *Lehman Bros. Special Financing, Inc. v. BNY Corporate Transaction Services Ltd. (In re Lehman Bros. Holdings Inc.)*[37] held that an *ipso facto* clause must be specifically set forth in the swap agreement to fall within the safe harbour and consequently a flip clause[38] for credit-linked notes in the transaction documents did not meet this test because subordination is not 'liquidation, termination, or acceleration' of the swap. According to the ISDA US law opinion, the interpretation of this decision is that the flip clause would not be considered to fall within the safe harbours even if it were incorporated in the swap agreement itself.[39]

Section 403 of FDICIA has a special standing under US law since it recognises the enforceability of the termination, liquidation, acceleration and netting of payment obligations between two financial institutions under a netting contract '[n]otwithstanding any other provision of State or Federal law', other than certain provisions of the FDIA, the OLA and other

33 MORRISON & RIEGEL (2015) 648.

34 According to Krimminger, the reference to similar agreements is intended to accommodate innovation in the markets so long as these innovations are similar to agreements already protected. See KRIMMINGER (2006) 14.

35 For instance, swap agreements clearly cover also forwards. In this case it may be argued that the more restrictive safe harbours of the Code do not restrict protection for counterparties under other provisions of the Code.

36 MORRISON & RIEGEL (2015) 648 & 652.

37 422 B.R. 407 (Bankr. S.D.N.Y. 2010). This judgment was confirmed *In Lehman Bros. Special Financing, Inc.v. Ballyrock (In re Lehman Bros. Holdings Inc.)*, 452 B.R. 31 (Bankr. S.D.N.Y. 2010).

38 The flip clause was intended to reverse the priority of payment obligations owed to swap counterparties on the one hand and noteholders on the other, following a specified event of default.

39 See ISDA US law opinion at p 17.

Federal statutes.[40] This provision, similar to the safe harbours, protects the exercise of various contractual rights, including termination and netting rights, notwithstanding the financial condition of the financial institution. Close-out and netting are again treated as separate but related rights. The interesting feature about this section 403, and the reason why it is being mentioned here, is that it recognises the protection of these rights 'in accordance with, and subject to the conditions of, the terms of any applicable netting contract.' The role given to party autonomy under this provision is reminiscent of the standard of 'in accordance with its terms' applied under the EU's Financial Collateral Directive.

According to the ISDA netting law opinion on US law, where a particular transaction is not specifically enumerated in the Code, it is expected that the court will find that the transaction deserves the same treatment as swap agreements under the Code, provided the transaction is concluded between financial institutions and the agreement is a netting contract in terms of section 402 of FDICIA.[41] The reasons for this statement is that the scope of application of section 403 of FDICIA is not restricted to any particular product with the only limitation being the nature of the parties, *i.e.* that they are financial institutions.[42] Thus, between them section 560 of the Code and section 403 of FDICIA virtually cover the whole spectrum of the financial market insofar as regards the protection of close-out netting provisions.

Perhaps the two most distinct features which have emerged from the above analysis is that rather than focusing on the protection of close-out netting as a single mechanism, US law protects more generally the exercise of contractual rights of which close-out and netting are deemed to be separate rights linked together in a financial contract. The second feature is that both set-off (or offset) and netting are considered as alternate methods for determining a single payment amount upon the close-out of a financial contract so that a close affinity may be attributed to these two concepts. This affinity is the subject of analysis in the next part of this chapter. As in the previous national law chapters, first an overview of the concept of insolvency set-off under US law is made and this is followed by a comparative analysis of the constitutive elements of both concepts. This analysis

40 These exceptions regard, *inter alia*, the regulatory and conservatory powers of the FDIC. Bergman *et al.* state that since FDICIA does not expressly prohibit a party from terminating an agreement as is the case under FDIA, the advice has been given by ISDA that a financial institution is able to exercise its close-out netting rights notwithstanding the FDIC's appointment as conservator. The FDIC, however, declared officially that in this situation FDICIA only enforces a party's netting rights but not the right to terminate an agreement. See BERGMAN *et al.* (2004) 19.

41 See ISDA 2018 Mayer Brown (the ISDA US law opinion) 14.

42 This is defined to include broker dealers, depository institutions, futures commission merchants and other entities recognised by the Federal Reserve regulation. On 7 March 1994 the Federal Reserve expanded the definition of financial institution to include most significant participants in the financial markets. See Regulation EE, 12 C.F.R. § 231.

will focus on the law of ordinary set-off rights as opposed to the exercise of offset rights related to the safe harbours which is considered later in this chapter.

6.2.1 Insolvency Set-off under US Law

The ordinary right of set-off under state law is primarily a matter of state substantive (as opposed to procedural) law.[43] Set-off is generally a voluntary act which must be invoked by the deliberate action of the creditor, thus indicating intent to effect set-off.[44] The Bankruptcy Code therefore does not create set-off rights, but only preserves set-off rights that arise under applicable non-bankruptcy law. In this regard, the relevant provision of the Code is section 553(a) which upholds the right of a creditor to set off mutual debts arising prior to the commencement of the bankruptcy proceedings '[e]xcept as otherwise provided in this section and in sections 362 and 363 of this title […].' Indeed, to the extent that a right of set-off existing under applicable state law may interfere with a provision of the Bankruptcy Code, the latter is supreme and the state law will be pre-empted.[45]

The recognition of state set-off rights in bankruptcy is entrenched in US legislative history. According to Morton, this recognition was initially codified in the Bankruptcy Act of 1800 and was later incorporated in the Bankruptcy Acts of 1841[46] and 1867,[47] the comprehensive Act of 1898[48] and the Chandler Act of 1938.[49] A number of restrictions found their way in the text of the various Acts and were carried forward in successive Acts. Thus, section 20 of the 1867 Act prohibited the set-off of obligations when acquired by the debtor after the filing of a voluntary petition or, in an involuntary case, after the act of bankruptcy. Section 68 of the Act of 1898 did not allow set-off if the mutual debts or credits were not provable or were acquired after the bankruptcy petition or within the previous four months

43 For an overview of the introduction of set-off in US state law, see SEPINUCK (1988) 53.

44 The courts have generally delineated three steps which must be followed to perfect a set-off, namely that the creditor decides to exercise set-off, takes affirmative action to do so and records the set-off. See *Baker v. National City Bank of Cleveland*, 511 F.2d 1016 96th Cir. 1975). See also *Contra United States v. Norton*, 717 F.2d 767 (3d Cir. 1983) where the court held that set-off is accomplished when a creditor gives sufficient evidence of intent to make a set-off such as the retention of funds by the creditor. Exceptions may arise in states where set-off is automatic such as under Pennsylvania law where no accounting record or other overt act is required to accomplish set-off.

45 Set-off, which is considered as an equitable right of a creditor to deduct a debt it owes to the debtor from a claim it has against the debtor arising out of a separate transaction, is y contrasted with recoupment (a notion derived from common law) in which the opposing claims arise from the same transaction. See US ATTORNEY MANUAL Part 65.

46 Bankruptcy Act of 1841, ch. 9, 5 Stat. 440, 1841-04-19.

47 Bankruptcy Act of 1867, 14 Stat. 517, 1867-03-02.

48 Bankruptcy Act of 1898, Pub.L. 55-541, 30 Stat. 544.

49 Bankruptcy Act of 1838.

intended for such use and with knowledge that the bankrupt was insolvent or had pursued an act of bankruptcy.[50]

Historically, US courts have considered that the availability of set-off runs counter to the fundamental policy underlying bankruptcy law, namely a fair and proportionate distribution to creditors. Prior to the Bankruptcy Reform Act of 1978, a trend towards restricting set-off rights was developing in the courts in particular in relation to a debtor undergoing a bankruptcy reorganisation.[51] Thus, the Supreme Court in *Lowden v. Northwestern National Bank*[52] noted that section 68 of the Act of 1898 was 'meant in its enactment to prescribe the rule of setoff upon a distribution of assets'[53] and advocated a case-by-case assessment whether to allow set-off in reorganisation cases in order to give the debtor or his trustee the possibility to propose a plan of reorganisation. This led to a series of judgments holding that the rehabilitative purpose of reorganisation would be frustrated if creditors were permitted to set off at an early stage of the proceeding. At the same time, set-off in liquidation cases was considered favourably even though this could lead to a distributional preference.[54] By the time of the promulgation of the 1978 Act, however, the trend in court judgments was that set-off was a fair and equitable process to satisfy creditor's claims. Its enforcement nowadays lies entirely within the discretion of the bankruptcy court and is generally enforced unless there exist 'compelling reasons' not to do so.[55]

Prior to analysing the restrictions on the exercise of set-off rights upon insolvency, consideration will be made of the basic constitutive requirements of set-off under US law resulting from common law and, where applicable, from the Bankruptcy Code provisions. This is followed by a review of the Code provisions regulating the relationship between set-off rights and the bankruptcy proceedings in relation to the automatic stay, restrictions on creditor preferences and provisions to avoid fraudulent transfers. The rationale for this analysis, as in the previous two chapters,

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50 MORTON (1976) 375.

51 For a discussion of the approach taken by jurists and the courts prior to the 1978 Bankruptcy Code towards set-off in a reorganisation procedure as being contrary to the 'fair and equitable' doctrine, see MORTON (1976) 384.

52 298 U.S. 160 (1936).

53 *Ibid.* 164.

54 For instance, see *Kolkman v. Manufacturers' Trust Co.*, 27 F.2d 659 (2 Cir. 1928); *Feakes v. International Trust Co.*, 8 F.2d 668 (D. Mass. 1925).

55 *United States v Carey (In re Wade Cook Fin. Corp.)*, 375 b.R. 580, 588 (B.A.P. 9th Cir. 2007); *In re NWFX, Inc.*, 864 F.2d 593 (8th cir. 1989); *In re Buckenmaier*, 127 B.R. 233 (Bankr. 9th Cir. 1991). Generally, courts have disallowed otherwise valid set-off in two categories of cases: (i) where the creditor committed an inequitable, illegal or fraudulent act, or the set-off is against public policy (see for instance *In re Cascade Roads, Inc.*, 34 F.3d 756 (9th Cir. 1994) where IRS set-off was denied because Government's conduct was inequitable) and (ii) where the set-off would significantly harm or destroy the debtor's ability to reorganise (see for instance *In re Cloverleaf Farmers Co-op*, 114 B.R. 1010 (Bankr. D.S.D. 1990) where set-off was denied because it was inconsistent with the purpose of Chapter 12 and the rehabilitation of American farmers).

is to gauge the extent to which close-out netting may be considered as a contractual enhancement of the concept of insolvency set-off.

Basic Requirements

It has been stated that section 553(a) of the Bankruptcy Code sets the parameters for the application of set-off rights as recognised by state law in relation to an insolvent debtor. It provides that a creditor seeking to exercise set-off must hold a 'claim' against the debtor. A 'claim' is widely defined under section 101(5) of the Bankruptcy Code to refer generally to any right to payment. A creditor seeking to exercise set-off must owe a 'debt' to the debtor. A 'debt' is defined in section 101(2) of the Bankruptcy Code as a 'liability on a claim'. The scope of the claim and debt is unrestricted except that they should constitute valid and enforceable obligations. According to Sepinuck, it is difficult to unequivocally establish the common requirements of set-off under state laws and no court or legislator has systematically laid down the elements necessary for set-off rights to accrue. Even if these issues are considered in one or more court judgments, the same reasoning is not necessarily followed in later judgments. Notwithstanding this, Sepinuck states that some basic requirements of set-off seem to command widespread consensus.[56] These basic requirements are indicated below.

Set-off is only possible in respect of mature obligations. It is, however, also typically permitted when, at the time the bankruptcy petition is filed, the debt is owed with certainty but is not presently due, or when a definite liability has accrued but is not yet liquidated.[57] Sepinuck notes that it is not clear from case law if there is an exception in relation to contingent debts upon the occurrence of insolvency. Unlike matured debts, contingent debts do not necessarily become due in time and the occurrence of insolvency may by itself be insufficient to warrant the possibility to set off claims.[58]

Debts must be liquid for the set-off to occur. If a debt remains unliquidated, for instance in relation to a claim based on a tortious injury, the debtor normally may not unilaterally determine the actual debt owed by the creditor. If agreement cannot be reached between the parties on a settlement, resort must be had to the courts in order to liquidate the claim through an estimation process. Sepinuck concludes that as a result set-off is typically restricted to liquidated debts.[59]

An essential requirement of the right of set-off is mutuality of debts. Thus, mutual debts, although not necessarily similar in nature, must be 'in the same right and between the same parties, standing in the same capacity', although, depending on the applicable state law, may not need to

56 SEPINUCK (1988) 67.
57 *In re Young*, 144 B.R. 45, 46-47 (Bankr. N.D. Tex. 1992).
58 SEPINUCK (1988) 68.
59 *Ibid*. 69.

arise from the same contract.[60] Thus, affiliated companies generally cannot aggregate their claims for set-off purposes. Indeed, as will be seen below, it is the purpose of the mutuality requirement to prevent what are referred to as 'triangular set-offs', namely a set-off among three or more affiliated entities. A creditor that takes an assignment of a third party's claim against a debtor satisfies the mutuality requirement and is eligible for set-off so long as the assignment occurred more than ninety days before the debtor filed for bankruptcy.

Some courts had created an exception to the general rule prohibiting triangular set-offs that permit set-off when the parties have entered into an express contractual agreement governed by US law to allow set-off among affiliates.[61] A decision of the US Bankruptcy Court in the District of Delaware, *Re SemCrude*[62] (*SemCrude*), overturned this exception and held that in a Bankruptcy Code proceeding, debts may be set off only where they are mutual in a strict sense, *i.e.* due to and from the same persons in the same capacity. According to the court, 'non-mutual debts cannot be transformed into a 'mutual debt' under section 553 simply because a multi-party agreement allows for set-off of non-mutual debts between the parties to the agreement.' The court considered that, contrary to the situation where one party guarantees another party's debts, an agreement to allow a set-off among affiliates does not create indebtedness from one party to another but simply recognises the parties' pre-existing rights to set off obligations. The court therefore chose to disregard principles of 'mutuality by contract' potentially available under state law in the light of the clear wording of section 553 of the Bankruptcy Code.

Restrictions on Insolvency Set-off

A first important restriction imposed on the application of set-off upon bankruptcy relates to the automatic stay. Section 362(a)(7) of the Bankruptcy Code provides that the commencement of a case in bankruptcy operates as a stay of 'the setoff of any debt owing to the debtor that arose before the commencement of the case […] against any claim against the debtor.' Section 553 of the Bankruptcy Code protects the set-off of mutual debts that

60 Joshua Cohn, 'Chapter 35: United States of America', in JOHNSTON *et al.* (2018), para 35.03. In this sense, the pre-petition debtor should also be treated differently from the DIP or the debtor's estate for set-off purposes.

61 This exception applies if the parties all agree in a pre-petition contract that a set-off may be taken between three parties, in the sense that two of them (typically affiliates) will be considered as a single entity for the purposes of the contract. The agreement may be enforced in bankruptcy to the extent it is enforceable under applicable non-bankruptcy law. The court *In re Lehman Brothers Inc*, 458 B.R.134, 141-2 (Bankr. S.D.N.Y. 2011), however, noted that this triangular set-off has been allowed only under state law or the common law of equitable receivership, but not under the more restrictive provisions of the Bankruptcy Code.

62 *Re SemCrude*, 399 BR 388, 396 (Bankr D. Del. 2009).

arose before the commencement of the bankruptcy case. Court approval is required to implement a right of set-off after the commencement of bankruptcy proceedings and a post-petition debt cannot set off a pre-petition debt so that both debts must be post-petition for the court to give its approval for the set-off.[63] Cohn explains that the automatic stay does not extinguish the right of set-off but postpones it pending an orderly examination of the debtor's and creditor's rights. In this respect, section 506(a) of the Bankruptcy Code provides that an 'allowed' claim[64] of a creditor that may be set off under section 553 of the Bankruptcy Code is treated as if it were secured to the extent of the amount subject to set-off. The creditor may preserve its rights by freezing the funds of the debtor in its hands but delay consummating set-off, while filing a proof of claim indicating the sum is held 'subject to' set-off without requesting relief from the stay until the bankruptcy trustee or debtor supplies adequate protection or compensation in terms of section 363 of the Bankruptcy Code. If adequate protection cannot be provided, relief from the automatic stay should be granted under section 362(d)(1) of the Bankruptcy Code.[65]

The second restriction relates to the prohibition of creditor preferences. Section 553(a)(2) of the Bankruptcy Code prohibits a creditor from setting off a claim that was transferred to it by a third party either after the commencement of the case in bankruptcy or within ninety days prior to the filing of the petition and while the debtor was insolvent. Section 553(a)(3) of the Bankruptcy Code further provides that where the creditor incurs a debt to the debtor, debts may not be set off when incurred within ninety days of filing and while the debtor was insolvent if they were incurred for the purpose of obtaining a right of set-off against the debtor. In addition, section 553(b) of the Bankruptcy Code provides that where a pre-petition set-off made during the ninety-day period has the effect of improving the creditor's position it will be recoverable by the trustee to the extent that the creditor has improved its position.[66] As an end result, Cohn states that since these preference provisions capture transactions that occurred up to ninety days prior to the commencement of the case in bankruptcy, the parties necessarily face a period of at least ninety days of uncertainty.[67]

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63 *Bank, N.A. v. Grant (In re Apex Int'l Mgmt. Servs., Inc.)*155 B.R. 591, 594-95 (Bankr. M.D. Fla. 1993). While the Bankruptcy Code specifically allows pre-petition set-off, it is silent regarding the setting off of post-petition claims. However, courts have generally allowed the parties to set off claims post-petition in the same manner as pre-petition. See for instance *In re Seal*, 192 B.R. 442, 457 (Bankr. W.D. Mich. 196); *In re Mohawk Indus.*, 82 B.R. 174 (Bankr. D. Mass. 1987).

64 Section 502 of the Bankruptcy Code establishes a broad standard for 'allowability' of claims.

65 Joshua Cohn, 'Chapter 35: United States of America', in JOHNSTON *et al.* (2018), para 35.15.

66 See CLARK (1981) 230. Clark states that the improvement in position rule under section 553(b) only applies to prepetition set-off. The reason behind this appears to be to discourage prepetition set-off and thus leave working capital by which the trustee or DIP can rehabilitate the debtor. *Ibid.*

67 Joshua Cohn, 'Chapter 35: United States of America', in JOHNSTON *et al.* (2018), para 35.20.

The third restriction relates to fraudulent transfers. Section 548 of the Bankruptcy Code allows a trustee to avoid any fraudulent transfers made within two years before the filing of the debtor's bankruptcy petition. In terms of this provision a fraudulent transfer is, in generic terms, any transfer of an interest of the debtor in property or any obligation incurred by the debtor made or incurred with actual intent to hinder, delay or defraud any entity to which the debtor is indebted at a time when the debtor was or could become insolvent. To the extent that an obligation of the debtor is a fraudulent transfer, it is likely that the trustee would avoid that obligation and thus it would not be available to be set off against any debts owed to the debtor.

6.2.2 Insolvency Close-out Netting and Insolvency Set-off Compared

A distinction needs to be made under US law between ordinary set-off rights and set-off (or offset) rights protected under the safe harbours. Ordinary set-off rights, as seen above, started to develop in the 1800s and are, in principle, subject to the automatic stay. Offset rights recognised under the safe harbours are protected in the same manner, and were developed at the same time, as netting rights.[68] For the purposes of this research, it is therefore proposed to compare the concept of close-out netting with the concept of ordinary set-off rights (as opposed to offset rights arising under the safe harbours) since the development of ordinary set-off rights is ingrained in US legislative history and allows for the assessment of the contractual enhancement of close-out netting. In doing so, it is first proposed to briefly indicate the differences in the scope of application of the two concepts before carrying out a more detailed comparison of their constitutive elements.[69]

Scope of Application

A first important distinction relates to the scope of application of the concepts of ordinary set-off and close-out netting. Ordinary set-off applies in respect of any type of obligations entered into between a creditor and a debtor, whether contractual or not so that tortious obligations may also be considered. The debt and the claim need not arise from the same transaction nor must they be of the same nature.[70] Alternatively, netting rights are protected under the safe harbours if (i) both parties are swap participants or financial participants to swap agreements in terms of section 560 of the

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68 Bergman *et al.* confirm that the right of offset under financial contracts does not meet the ordinary set-off requirements under state law. See BERGMAN *et al.* (2004) 21.

69 Consistent with the approach taken in this chapter, the analysis will focus on the close-out netting safe harbour provided in section 560 of the Bankruptcy Code, with reference being also made to section 403 of FDICIA where deemed relevant.

70 See US ATTORNEY MANUAL Part 65.

Bankruptcy Code or (ii) they benefit from a master netting agreement in relation to protected agreements in terms of section 561 of the Bankruptcy Code or (iii) they are financial institutions to netting contracts as defined under section 402(14) of FDICIA. It has been noted in part 6.2 of this chapter that given the wide definitions of swap agreements, swap participants and financial participants under the Bankruptcy Code, Morrison and Riegel have commented that these definitions are considered wide enough to extend to all derivatives contracts and to any parties and not just swap and financial parties. Given that both netting and offset rights are protected under the safe harbours, ordinary set-off rights are therefore applicable in respect of all other contracts which are not swap agreements under section 560 of the Bankruptcy Code or other financial contracts protected under a master netting agreement in terms of section 561, if the requirements of section 553 of the Bankruptcy Code are fulfilled.

Basic Requirements

It is to be borne in mind that under US law the ordinary right of set-off is created by state law and only preserved by the Bankruptcy Code, so that for certain aspects of the comparative analysis of the basic requirements reliance will be placed on doctrine and common law as already cited above. It is further proposed to consider whether close-out in the form of termination and acceleration applies also to ordinary set-off as it applies to netting.

Mutuality is a basic requirement for set-off to apply meaning that the obligations are held by the same parties in the same capacity and both arise either pre-petition or post-petition. It has been seen in part 6.2.1 that the court in *SemCrude* denied the benefits of set-off under section 553 of the Bankruptcy Code in the case of triangular set-off arrangements for lack of mutuality. Following this decision, it was questioned whether a right of set-off under a swap agreement which is not allowable under section 553 for lack of mutulity is nonetheless protected if it fulfils the requirements of the safe harbours. According to Bienenstock, if the relevant contracts fall under any of the safe harbour provisions and if the triangular set-off agreement is intended to serve as credit enhancement, the creditor could invoke the safe harbour since the safe harbour provisions override any provision of the Bankruptcy Code, including section 553. Bienenstock notes that the term 'contractual right' is broadly defined under section 560 of the Bankruptcy Code to include a right 'whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice' that it would appear that the language of the safe harbour provisions lifts the mutuality requirement necessary for the exercise of ordinary set-off rights.[71]

71 BIENENSTOCK *et al.* (2009) 338.

This reasoning was, however, refuted by the court in *In re Lehman Brothers Holdings Inc.* (*Swedbank*)[72] and *In re Lehman Brother Inc.*[73] where it was noted that the safe harbour provisions do not modify the fundamental principles of section 553 requiring mutuality and, in the absence of an express mention of mutuality in sections 560 and 561 of the Bankruptcy Code, the court declined to read an exception into the safe harbour provisions. It held that whilst the safe harbours permitted the exercise of the contractual right of offset in connection with swap agreements notwithstanding the operation of any provision of the Bankruptcy Code to stay, avoid or otherwise limit that right, however that right must exist in the first place. In *Swedbank* the court added that the requirement for both obligations to be pre- or post-petition for mutuality to subsist should also apply under the safe harbours.[74] The need for mutuality to exist for close-out netting is confirmed in section 403 of FDICIA where the protection of close-out netting in bilateral netting is granted in arrangements 'between any 2 financial institutions'.

Other than for observance of the mutuality requirement, no other requirement restricts the exercise of contractual rights under the safe harbours so that these may be exercised even if the respective obligations are not mature or liquid as long as the modality for calculating 'termination values' and 'payment amounts' following the close-out is foreseen in the swap or other protected agreement.[75] The situation is not so liberal in relation to ordinary set-off rights even though the courts may intervene to facilitate the fulfilment of certain requirements. Thus, debts which are not liquid may in the end be rendered liquid through the intervention of the courts which perform an estimation process. Similarly, whilst it is possible to accelerate the maturity of debts to permit ordinary set-off of obligations that are certain or have accrued but are not yet liquidated, it has been stated that the courts generally prohibit the set-off of debts which are contingent on some event which has not yet occurred.

Although US courts may permit the acceleration of the maturity of obligations under set-off (except where the maturity depends on the occurrence of a contingency which has not yet materialised), this may not be equivalent to the right to close out exercisable under the safe harbours. Indeed, the question arises whether the exercise of ordinary set-off rights upon insolvency is also associated or is preceded by the close-out of a contract or the

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72 *In re Lehman Brothers Holdings Inc. et al.*, 433 B.R. 101, 109 (Bankr. S.D.N.Y. 2010). This case concerned the set-off of pre-petition funds with post-petition funds.

73 *In re Lehman Brothers Inc*, 458 B.R.134, 142-3 (Bankr. S.D.N.Y. 2011). This case concerned set-off under a triangular arrangement.

74 *In re Lehman Brothers Holdings Inc. et al.*, 433 B.R. 101, 112 (Bankr. S.D.N.Y. 2010).

75 In terms of the ISDA US law opinion, party autonomy extends to the selection of the currency in which the close-out netting amount may be denominated although for the purposes of US insolvency proceedings, any claims of the counterparty of the debtor or any judgment in favour of the counterparty that is denominated in a currency other than US dollars must be converted into US dollars. See the ISDA US law opinion at p 14.

termination or acceleration of obligations. It is doubtful whether the acceleration of the maturity of obligations of ordinary set-off rights is equivalent to the termination or acceleration of those obligations.[76] Under section 362(a)(7) of the Bankruptcy Code, the automatic stay is imposed on the set-off of any debt that 'arose before the commencement of the case under this title against any claim against the debtor.' Section 553(a) of the Bankruptcy Code only allows the exercise of ordinary set-off rights if both the creditor's and debtor's claim and debt arose before ninety days from the date of the filing of the petition. Thus, even if the maturity of debts subject to ordinary set-off may at times be accelerated by the court, it cannot be stated that the law foresees the possibility to close out contracts in order to permit the exercise of ordinary set-off rights. This conclusion is strengthened by the fact that whilst section 560 of the Bankruptcy Code protects *ipso facto* clauses and foresees the possibility to terminate a protected contract 'because of a condition of the kind specified in section 365(e)(1) of this title', no such possibility exists for the exercise of ordinary set-off rights.

The difference between the concepts of ordinary set-off and close-out netting is perhaps most apparent from two additional aspects. First, US law has created the notion of safe harbour set-off which, for all intents and purposes, is also preceded by close-out and benefits from the same safe harbour protections as netting. Under the safe harbours, set-off and netting are considered as two alternate modalities that may be used for the calculation of a close-out amount. In this sense, the safe harbour set-off does not seem to require observance of the basic requirements of ordinary set-off, other than mutuality, for its validity. Secondly, whilst the concept of ordinary set-off gradually became to be considered a fair and equitable process for the payment of debt, it shall be seen in the latter part of this chapter that close-out netting developed mostly out of concerns of systemic risk which the insolvency of a financial institution could bring on the market.[77] It does not appear from the various considerations and declarations made by Congress during the successive expansions of the safe harbours that these were based on considerations of equity or fairness. On the contrary, the safe harbours were enacted on the understanding that considerations of equity and fairness had to give way to considerations of protecting the market against systemic risk. All in all, given the different standards and considerations which nowadays surround the concept of close-out netting it may be fair to state that it goes beyond the notion of being a contractual enhancement of ordinary set-off and may be considered as a completely separate concept.

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76 It is also important to reiterate the point made in part 6.2.1 that claims and debts which may be subject to ordinary set-off do not necessarily arise by contract but may result from a tortious situation. In this case, the acceleration of the maturity of an obligation is not tantamount to the close-out of a contract.

77 It may be for this reason that the exercise of safe harbours set-off developed differently from ordinary set-off.

Insolvency Proceedings

Whilst the creditor of an ordinary set-off right is generally subject to the automatic stay and to the ninety-day suspect period, the safe harbours insulate the holders of protected contracts from most avoidance powers such as preferences and fraudulent transfers, other than fraudulent transfers with actual intent to hinder, delay or defraud creditors.[78] Indeed, in terms of section 560 of the Bankruptcy Code, the exercise of protected contractual rights 'shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.' For instance, a situation where the liquidation of protected contracts may be deemed a preference or constructively fraudulent transfer and hence voidable, is when it is entered into after the derivative trading has begun and it produces the effect of obliging the debtor to assume a debt without any corresponding benefit to it and while the debtor is insolvent.[79]

6.3 The Recognition of Close-out Netting Provisions Before and After the Adoption of a Bank Resolution Regime

The law on the safe harbours started to evolve with the adoption of the new Bankruptcy Code in 1978.[80] The protection of close-out netting provisions developed in a piecemeal fashion whereby the protection of certain contracts under the Bankruptcy Code resulted in the protection of the clauses and contractual rights typically found in these contracts. With each amendment, the protection of contractual rights was viewed as crucial to protect the viability of both the individual counterparties and of the relevant market. According to Krimminger, this underlying goal remained consistent throughout the gradual expansion of these protections from 1978 to the new Title IX of FDIA enacted by the Bankruptcy Reform Act of 2005.[81] It is proposed to first analyse the expansion of the safe harbours, including the rationale therefor, in order to assesses the extent of recognition given to close-out netting provisions. This is followed by an examination of the extent to which applicable resolution regimes have restricted the enforcement of close-out netting rights.

78 See 11 U.S.C. § 546(e) to (g).
79 BIENENSTOCK *et al.* (2009) 340.
80 Bankruptcy Reform Act of 1987, Pub.L. 95-598, 92 Stat. 2549.
81 KRIMMINGER (2006) 7.

Expansion of Bankruptcy Code Safe Harbours

The initial exemptions of 1978 included two provisions granting limited protection to commodity and forward contracts from the automatic stay for non-debtor forward merchants and brokers with respect to margin payments or deposits received from a debtor.[82] These safe harbours were intended to 'promote customer confidence in commodity markets' by protecting the commodity market stability.[83] These protections were extended in 1982[84] to the securities contracts and to the margin and settlement payments of brokers, clearing organisations and financial institutions.[85] These initial safe harbour expansions were narrow in scope. As amended in 1982, sections 555 and 556 only extended safe harbour protections to a select, narrowly-defined group of financial contracts and the right to liquidate a securities contract was granted only to a limited group of parties also narrowly defined to include stockbrokers and securities clearing agencies. In addition, the safe harbours only exempted from the automatic stay the contractual right to cause liquidation which was strictly limited to those rights 'set forth in a rule or bylaw of a national securities exchange, a national securities association, or a securities clearing association', so that the rights deriving exclusively from the securities contract itself were not protected.

Following this expansion, some court decisions raised doubts whether repo agreements were protected for closing out positions under the safe harbours.[86] This led to a further expansion of the safe harbours in 1984[87] to cover repurchase agreements and included the exemption of the set-off of repo obligations from the automatic stay and the protection of margin and settlement payments for repos from avoidance. The amendment also broadened the range of parties entitled to the exemptions beyond specific and defined parties but imposed a ninety-day limit for the allowability of obligations. A repurchase agreement, however, was narrowly defined to agreements for the transfer of certificates of deposit, bankers' acceptances or

82 See Act of Nov. 6, 1978, Pub. L. No. 95-598, 92 Stat. 2549. In this respect, section 362(b)(6) of the Code provided an exception to the automatic stay for the set-off of claims under commodity and forward contracts. Section 546 (originally section 764(c)) of the Code prevented a debtor or trustee from avoiding and recovering settlement and margin payments on commodity and forward contracts made by the debtor before the bankruptcy filing.

83 S. Rep. No. 989, 95th Cong., 2d Sess. 8, reprinted in 1978 U.S.C.C.A.N. 5785, 5794.

84 See Act of July 27, 1982, Pub. L. No. 97-222, 9 Stat. 235.

85 This extended protection was added by 11 U.S.C. § 546(f).

86 See in particular *Lombard-Wall, Inc. v. Columbus Bank & Trust Co.* No. 82B 11556 (Bankr. S.D.N.Y. 1982) where the court held that the automatic stay barred the holder of securities under a repo from closing out its positions without approval by the court.

87 This expansion was enacted via sections 362(b)(7), 546(f) and 559 of the Bankruptcy Code through the Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-252, 98 Stat. 333.

US government securities.[88] In 1984 Congress added 'financial institution' to the list of protected parties in sections 546(e), formerly 546(d), and 555, which was widely defined.[89] The term 'contractual right' was more broadly defined to include, besides written rules of relevant market associations, any right 'whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.' In addition, the authorisation to liquidate a repurchase agreement notwithstanding the automatic stay included permission to foreclose on the underlying collateral.

In 1990 Congress extended the protection from the automatic stay and avoidance powers to swap agreements through the introduction of section 560.[90] The 1990 amendment added to the scope of the existing safe harbours an important aspect in that it explicitly protected the exercise of netting rights. The reason for this addition was that since swaps are traded between parties according to conventions established in master agreements, the industry feared that without an explicit exemption in the Bankruptcy Code the practice of netting would be prevented by the automatic stay.[91] In addition, unlike previous amendments which gradually opened up the safe harbours to limited types of derivatives agreements, section 560 extended safe harbour protections to all swap participants, a term broadly defined to include any 'entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor.' As noted in part 6.2, the term 'swap agreements' was also widely defined to include a long list of derivatives transactions as well as 'similar' agreements and any collateral or credit enhancements[92] and since none of the transactions mentioned in the definition were themselves defined, a judge was presumably expected to rely on market definitions.[93] The source for the contractual rights was also expanded to cover any liquidation or termination of a forward contract, even those arising from 'any right […] under common law, under law merchant, or by reason of normal business practice, whether or not evidenced in writing.'[94] This indicates that the enforcement of close-out netting may go beyond the confines of contractual provisions and extend to customary law and *lex mercatoria*. Admittedly, this may be just a relic of the wording used in the older safe harbours[95] so that today close-out netting in relation to swaps is more likely to be exercised under contractual provisions rather than customary law. Indeed, unless the modalities for calculating

88 See Act of July 10, 1984, Pub. L. 98-353 (HR 5174), amending 11 U.S.C. § 101(36).
89 11 U.S.C. § 101(19) (1984).
90 See Act of June 25, 1990, Pub. L. No. 101-311, 104 Stat. 267.
91 SCHWARCZ & SHARON (2014) 1730.
92 11 U.S.C. § 101(49)(A).
93 See MORRISON & RIEGEL (2015) 646.
94 Act of June 25, 1990, Pub. L. No 101-311 tit. II, sec. 205, § 556, 104 Stat. at 267.
95 Namely, sections 555, 556 & 559 of the Bankruptcy Code.

close-out amounts are set by contract, it is no longer feasible to exercise close-out netting rights of complex and innovative derivatives products on the basis of unwritten customary practices as permitted in section 560 of the Code.

Another major statutory change occurred in 1991 with the adoption of FDICIA which confirmed the enforceability of the netting of payment obligations among financial institutions under a netting contract '[n]otwithstanding any other provision of State or Federal law'[96] and notwithstanding any 'stay, injunction, avoidance, moratorium or similar proceeding or order, whether issued or granted by a court, administrative agency, or otherwise.'[97] FDICIA is particularly significant because, unlike the Bankruptcy Code, it is not linked to specific types of contracts. As a result it is deemed to provide broader netting rights and according to Krimminger may have solved any doubts in relation to those safe harbours which did not explicitly exempt netting provisions from the effects of the Bankruptcy Code.[98] This is confirmed by the ISDA US law opinion where it is deemed that '[…] because Congress intended to reduce systemic risk in enacting Sections 401-407 of FDICIA, it appears that the correct view would be to construe broadly the application of FDICIA so as to include Transactions that may not fall within the definition of "swap agreement", provided both parties are financial institutions.[99] However, this extended protection is provided only to financial institutions that meet certain thresholds qualifying them as major market dealers.[100]

In 2005 the Bankruptcy Abuse Prevention and Consumer Protection Act[101] (BAPCPA) was enacted to provide a common set of rules covering all participants in the financial markets. According to Schwarcz and Sharon, BAPCPA 'gave free rein to derivatives counterparties to completely circumscribe the Bankruptcy Code's automatic stay and preference rules.'[102] It did so by first expanding the Code's definitions of 'securities contract', 'commodities contract', 'forward contract', 'repurchase agreement' and 'swap agreement'[103] to provide safeguards for broad segments of the derivatives market. Secondly, BAPCPA expanded the safe harbours by the

96 Exceptions to this statement include 12 U.S.C. § 1821(e) on powers of conservators and receivers under FDIA with respect to contracts entered into before appointment of the conservator or receiver; 12 U.S.C. § 5390(c) which is the corresponding provision of the Dodd-Frank Act; and any order authorised under Section 5(b)(2) of the Securities Investor Protection Act of 1970.

97 See, generally, 12 U.S.C. § 4401-4407.

98 KRIMMINGER (2006) 8.

99 See ISDA US law opinion at p 33.

100 See WALDMAN (1994) 1076. The definition of financial institutions for the purposes of section 403 of FDICIA was referred to in part 6.2 and is similar to the definition of financial participant for the purposes of BAPCPA, considered below.

101 Pub.L. No. 109-008 (2005).

102 SCHWARCZ & SHARON (2014) 1733.

103 See BAPCPA §§ 907, 101(25), 101(53B),741(7) & 761(4).

addition of a general definition of financial participant,[104] thus bringing within the scope of the safe harbours large institutions not covered by the other definitions. Thirdly, the terms 'master netting agreement' and 'master netting agreement participant' were added to the list of protected contracts and protected parties, and provision was made for the exercise of cross-product netting, set-off, liquidation, termination, acceleration or close-out rights with respect to securities contracts, commodity contracts, forward contracts, repos and swap agreements.[105]

Further expansions occurred in 2006 through the enactment of the Financial Netting Improvements Act of 2006.[106] The section 362 Bankruptcy Code exemptions from the automatic stay were substantially reworded to bring them in line with similar provisions in FDIA and the Federal Credit Union Act. Sections 546(e) and (j) were expanded in scope to protect all types of transfers made by the protected parties from the trustee's avoidance powers.

According to Edwards and Morrison, the end result of this gradual expansion is that counterparties to a derivatives securities contract may now terminate, modify or liquidate assets of the debtor unhindered by the bankruptcy filing of a debtor if they hold other assets of the debtor they can use to reduce their exposures through an offset or netting.[107] It would thus appear that there is nothing to fetter party autonomy in the exercise of close-out netting rights under the US safe harbours. This has given rise to the question posed by Peck, Mokal and Janger whether the bankruptcy safe harbours have evolved to the point that:

> 'they have become so overly broad and all-encompassing that they frustrate some of the fundamental rehabilitative and distributive goals of bankruptcy by embracing transactions with little or no systemic significance that do not deserve to be immunized from collective bankruptcy treatment.'[108]

Although later developments did not go in the direction of the question raised by these authors, the free rein given to party autonomy started to be restricted in relation to systemically important institutions by the establishment of special resolution regimes, underlying a new understanding by Congress that the protection of systemic risk brought new considerations of

104 A financial participant includes any entity that, at the time it enters a securities contract, commodity contract, swap agreement, repurchase agreement or forward contract, or at the time of filing of its bankruptcy petition, holds a total of $1 billion in notional or actual principal amount of derivative transactions or gross mark-to-market positions of not less than $100,000,000 aggregated across parties, in one or more agreements with the debtor on any day during the prior fifteen-month period.

105 BAPCPA §§ 907, 101(38A).

106 Act of December 12, 2006, Pub. L. No 109-390, 120 Stat. at 2692.

107 EDWARDS & MORRISON (2005) 3.

108 PECK *et al.* (2011) 17.

financial sector stability which resulted in the controlled exercise of close-out netting rights.

Bank and Other Resolution Regimes

It will be recalled that the two US resolution regimes, the FDIA and the OLA regimes, operate in different ways. Whilst all insured credit institutions falling within the scope of FDIA are regulated by FDIA to the exclusion of the Bankruptcy Code,[109] the OLA regime only applies to non-bank financial institutions which are determined under the OLA regime to be systemically important. Once a determination has been made under the OLA regime, these institutions are no longer governed by the Bankruptcy Code.[110] Both regimes protect the right of parties to qualified financial contracts (QFCs) to close out, offset and net, and exercise security or credit enhancement rights,[111] but both also impose certain restrictions on these rights to protect the resolution of institutions which they govern. QFCs are defined to include securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements.[112]

Thus, FDIA reinforces the statutory ban on *ipso facto* clauses triggered solely on grounds of the financial condition of the institution and the appointment of the FDIC as receiver and temporarily stays the exercise of close-out netting rights until the earlier of 5:00 p.m. (eastern time) on the business day following the date of the appointment of the receiver or of a notice of transfer of the contracts to another bank or to an FDIC-owned bridge bank.[113] It was debatable in relation to the safe harbours whether counterparties could terminate agreements and destroy value to a receiver by the use of walkaway clauses which entitle a solvent party to suspend or extinguish a net payment right or avoid payment solely because of the status of the insolvent counterparty as a defaulting party under the contract. The FDIA regime brought an end to this uncertainty by prohibiting outright this type of clauses.[114]

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109 See in this regard, CAMPBELL & MOFFATT (2015) 70. It is also to be noted that the US bank resolution regime is much older than the English and French bank resolution regimes.

110 This is confirmed in LUBBEN (2017) 69.

111 12 U.S.C. §§ 1821(e)(8)(A) & 5390(c)(8)(A).

112 12 U.S.C. §§ 1821(e)(8)(D)(i) to (vi) & 5390(c)(8)(D)(i) to (vi). These definitions are broader than those of the Bankruptcy Code since they define certain protected contracts more inclusively and do not include the Code's limitations of protection only to specified counterparties. The term QFC also extends to any 'similar agreement' that the FDIC determines by regulation, resolution or order to be a qualified financial contract.

113 In conservatorship, the general rule against the enforceability of *ipso facto* clauses applies. Counterparties may not terminate, close out or net QFCs solely on account of the insolvency, financial condition or appointment of the conservator. This in effect continues all relationships under their existing contractual provisions. See 12 U.S.C. § 1821(e)(10)(B)(i) & (ii).

114 This applies in both receivership and conservatorship. See 12 U.S.C. § 1821(e)(8)(G)(i).

Some safeguards have also been put in place. The receiver or conservator may not avoid any transfer of money or other property in connection with the QFC, unless the transferee had actual intent to hinder, delay or defraud the institution, the creditors of the institution or any receiver or conservator of the institution.[115] If the receiver is to transfer any QFCs to a third party, the receiver must transfer all QFCs with the same counterparty, including its affiliates, to one depository institution transferee and notify the QFC counterparty of the transfer by a specific deadline on the business day after appointment of the receiver.[116] These safeguards ensure to some extent that the close-out netting mechanism, although temporarily delayed in implementation, remains intact.

The OLA regime continues to offer safe harbours for QFCs, similar to those offered by FDIA. These safe harbours are potentially broader than those of the Bankruptcy Code because they apply to all QFC counterparties and not only to the counterparties listed for protection under the Code. Similar to FDIA, it further provides that neither payments made nor collateral transferred by a covered financial company in connection with a QFC may be avoided by the FDIC except where the transferee intended to 'hinder, delay, or defraud' the creditors or the receiver of the covered financial company.[117] In addition, in a transfer of assets the FDIC may not cherry-pick among QFCs and if any QFC with a given counterparty is transferred, all QFCs with that counterparty or its affiliates must be transferred to the same party, together with all claims, security and credit enhancements.[118] However, *ipso facto* clauses related to the exercise of termination, netting and set-off rights solely on account of the appointment of the FDIC as receiver or the financial conditions of the financial company in receivership are stayed from the moment the receivership commences until 5:00 p.m. on the next business day or until the protected party has received notice that its QFC has been transferred to another financial institution, including a bridge financial company.[119] OLA also nullifies walkaway clauses which are solely based on the financial institution's insolvency or the appointment of the FDIC as receiver.[120] In terms of the ISDA US law opinion, these provisions considered together 'should ensure that credit exposures to an insolvent covered financial company can be calculated on a net basis pursuant to the terms of an ISDA Master Agreement',[121] thus confirming the statement made earlier in relation to FDIA that the close-out netting mechanism remains functional, although its operation is temporarily delayed.

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115 12 U.S.C. § 1821(e)(8)(C)(i) & (ii).
116 12 U.S.C. § 1821(e)(9) & (10).
117 12 U.S.C. § 5390(c)(8)(C).
118 12 U.S.C. § 5390(c)(9)(A).
119 12 U.S.C. § 5390 (c)(10)(B) & (D).
120 12 U.S.C. § 5390 (c)(8)(F)(i) & (iii).
121 See ISDA US law opinion at p 30.

Adams notes that whilst the Dodd-Frank Act provides numerous tools for systemic risk dispersion, the Bankruptcy Code safe harbours may interfere with the effectiveness of the ability for the FDIC to intervene after a non-bank financial institution determined to be systemically important has filed for bankruptcy.[122] According to Adams, once a bankruptcy has triggered the exercise of liquidation rights within the derivative safe harbours, OLA intervention is without effect. This is due to the fact that whilst OLA contains a stay on *ipso facto* clauses, there is nothing to empower OLA to assume a contract that had already been terminated and closed out. Congress' concern under OLA is about systemic risk and not about the resolution of the debtor. Thus, OLA must quickly decide whether there is systemic risk before the debtor takes action to file for bankruptcy. According to Adams, this places the decision when an institution is in financial distress in the hands of the person least able to evaluate it, the distant policy-maker, and may serve to hasten the decision-making in cases where insufficient information is available, thereby 'creating the potential for less resolute action and unhelpful political reactions.'[123] It also evidences that the exercise of party autonomy in relation to the safe harbours may trump the more restrictive OLA regime if the bankruptcy regime is put in motion before a determination of systemic importance has been made under the OLA regime.

6.4 Rationale of US Insolvency Law

Referring to the safe harbours, Faubus notes that no other financial instrument 'receives such preferential treatment under the Bankruptcy Code.' He states that whilst the purpose for this favourable treatment according to legislative history is to regulate systemic risk, the understanding how Congress intends the safe harbours to reduce systemic risk requires an understanding of the basic mechanics of bankruptcy proceedings.[124] It is the scope of this part of Chapter 6 to analyse the interaction of the recognition granted to close-out netting provisions under the safe harbours with the rationale and general principles of US insolvency law. The ulterior motive behind this analysis is to understand the justification for the policy goals that led to the recognition of close-out netting provisions in derogation of these general insolvency principles.

Given and Philipps note that from its inception 'as a colonial alternative to the English debtors' prisons' US bankruptcy law has been founded on two pillars, namely the discharge for the debtor and the equality of treatment for the debtor's creditors. According to these authors, discharge

122 12 U.S.C. § 5388.
123 ADAMS (2014) 109.
124 FAUBUS (2010) 823.

encourages risk-taking by offering the deserving debtor the possibility of a fresh start, whilst equality of treatment of creditors promotes a fair and orderly liquidation of the debtor's assets.[125] In this respect, Warren states that Congress realised that if legal rules make it difficult for a troubled firm to survive or if they increase the costs of operation, value will necessarily decline sharply when a firm is in trouble. Conversely, if the rules give the business opportunities to reorganise its debt and offer protection from collecting creditors, the rules will prop up the value of the troubled business.[126] It would thus seem that two important aspects that have shaped the rationale of the US insolvency regime are the encouragement of risk-taking and giving the failed debtor a second chance.

Under the Bankruptcy Code, if a bankruptcy petition is filed voluntarily or involuntarily for a debtor, the Bankruptcy Code broadly provides a system of rules designed to achieve rehabilitation or liquidation and payment of some portion of the debts due to creditors. Chapter 11 establishes a reorganisation procedure whose policy objective, according to Finch, is strongly oriented to the avoidance of the social costs of liquidation and the rehabilitation of the corporate operation. There is no requirement for the debtor to be insolvent or near insolvent[127] in order to trigger the Chapter 11 protection which may indicate that the process is an instrument for debtor relief, not a remedy for creditors.[128] McCormack, however, considers that the approach to bankruptcy reorganisation has changed and the objective of maximising creditor recoveries has come to assume a greater prominence so that asset sales have begun to predominate rather than reorganisations in the traditional sense. Thus, McCormack states that the 'pre-packaged' bankruptcy, which he considers to have gained in importance, mixes elements from private restructuring whereby agreement is reached with creditors on the restructuring process and the traditional Chapter 11 which is used to implement the agreement.[129]

In a regime which has pro-debtor tendencies, the obvious question which arises is how the safe harbours, with their evident pro-creditor approach, fit in this scenario? The safe harbours have, as a matter of policy, been justified by the effort of Congress to counteract systemic risk by excepting derivatives and other financial contracts from several key bankruptcy rules.[130] Ayotte and Skeel note that although the safe harbours could reduce systemic risk in some cases, they may 'throw oil on the fire' in others.

125 GIVEN & PHILIPPS (1982) 735.

126 WARREN (1993) 344.

127 The Bankruptcy Code sets a balance sheet test for determining insolvency in the case of entities and partnerships. See 11 U.S.C. § 101(32)(A) & (B).

128 FINCH & MILMAN (2017) 195.

129 McCORMACK (2009) 119 &128.

130 In terms of section 560 of the Bankruptcy Code, swap agreements 'shall not be stayed, avoided, or otherwise limited by operation of any provision of this title [11] or by order of a court or administrative agency in any proceedings under this title.'

Thus, the counterparties' ability to execute their contracts when a debtor files for bankruptcy can create a run on the debtor's assets as other counterparties also proceed to terminate their contracts and to seize any collateral securing the contracts. This was the situation with Lehman Brothers where the simultaneous closing out of these contracts threatened to create chaos both in the Lehman bankruptcy and in the derivatives market generally.[131] The situation was controlled to an extent by netting and by the inability of many counterparties to retrieve assets to satisfy their claims. In a different scenario, it was the possibility to seize collateral that led to the collapse of AIG. When AIG's financial situation deteriorated, its counterparties forced the insurer to begin posting collateral which led the company to liquidate assets, thereby destroying going-concern value which is something that the US bankruptcy regime is meant to avoid.[132]

With the experience gained from the financial crisis, the development of the law through the FDIA and OLA regimes has brought a shift in the objectives of the resolution of banks and systemically important non-bank financial institutions. Thus, whilst the Bankruptcy Code is designed generally to rehabilitate the debtor or to maximise the going-concern value, a resolution regime may allow the regulators to give consideration to the impact on the economy and financial markets. Thus, the systemic risk exception in the FDIA is an example of taking market impact into account where the main concern is to avoid bank runs.[133] Another example comes from the OLA regime which relies for its implementation on a determination based on the likely impact of a covered financial company's default on financial markets and the economy.[134] This allows regulators to take action in a regulatory resolution regime that is intended to limit the impact of the troubled institution's insolvency on entities other than its creditors or on the economy and the financial system.

Summing up, Adams notes that the derivative safe harbours are oriented towards termination and liquidation, particularly for parties where derivatives make up a large part of their assets base and cannot be explained in the light of the objectives of either the bankruptcy regime or any of the resolution regimes. In this situation, he considers that the focus on liquidation, termination and acceleration of the derivatives safe harbours 'stands out as an oddity' and demands 'justification'.[135] Just how much of an oddity the safe harbours are will be assessed in the following part dealing with insolvency law principles and just how much justification can be demanded will be considered in the last part dealing with the effect of public policy and state goals on US insolvency law.

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131 *In re Lehman Brothers Holdings Inc. et al.*, 433 B.R. 101 (Bankr. S.D.N.Y. 2010).
132 AYOTTE & SKEEL (2009) 494.
133 12 U.S.C. § 1823(c)(4)(G). See JANGER & POTTOW (2015) 156.
134 See section 203 of the Dodd-Frank Act.
135 ADAMS (2014) 108.

6.4.1 Principles Upheld by US Insolvency Law

US insolvency law has implemented principles intended to safeguard the objectives of the insolvency regime. These principles have already been referred to at the beginning of this chapter. In this part, a more detailed analysis of two of these principles, namely the automatic stay and the 'assume-and-reject' power, will be made as these principles are deemed to be central in the fulfilment of the rationale of US bankruptcy law and its tendencies to protect the interests of the debtor. This is followed by an assessment of the impact of the exercise of close-out netting rights on these principles.

Principles

When a debtor files a bankruptcy petition, it immediately enjoys the protection of the Bankruptcy Code's automatic stay provision, which is intended to restrain creditors from acting individually to enforce their claims over the property of its estate. Congress created this mechanism with the intention to serve as 'one of the fundamental debtor protections provided by the bankruptcy laws.'[136] Since this protection could have had an unfair impact on the rights of creditors, Congress deemed that the automatic stay would not extinguish creditors' rights, but would merely prevent enforcement 'pending an orderly examination of the debtor's and creditors' rights.'[137] Roe and Adams consider that the concept behind the automatic stay is that the whole firm can be worth more than the sum of its parts. The stay is designed to determine whether the firm has going-concern value, to allow the firm to realise such value and then to distribute the proceeds to the widest possible group of creditors. Other bankruptcy rules are in place to ensure that a firm that has going-concern value is kept intact. Thus, fraudulent conveyances of the debtor's assets before bankruptcy for inadequate value can be returned to the bankrupt business and *ipso facto* clauses that make the filing of the bankruptcy an event of default are generally unenforceable.[138]

The automatic stay is also beneficial to creditors, even if this is not its primary target. According to Edwards and Morrison, because a firm in distress is akin to a scarce resource, without some form of control of its assets, creditors would have unlimited rights of access to the debtor's property.[139] The result is that the first creditors to utilise the debtor's resources would be satisfied, while those who enforce their claims later might end up with nothing. This effect has been referred to as the 'grab-race' in part 6.1.

136 S. Rep. No. 989, 95th Cong., 2d Sess. 54(1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5840.
137 H.R. Rep. No. 595, 95th Cong., 2d Sess. 342 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6298.
138 ROE & ADAMS (2015) 377.
139 EDWARDS & MORRISON (2005) 95.

Without the protection of the automatic stay, creditors who are first in time will be satisfied 'even if the [debtor's] resource[s] would have more value per user if exploited in a more restrained manner.'[140] Similarly, the automatic stay prevents secured creditors from seizing collateral when the debtor fails to repay the loan and subsequently files a bankruptcy petition.[141] According to Baird and Jackson, removal of collateral, especially collateral that is essential to the firm's survival, may benefit the individual secured creditor to the detriment of other creditors since it dismembers a firm and destroys its value.[142]

The second basic principle relates to the debtor's or trustee's power to assume or reject contracts, subject to court approval. According to Lubben, the debtor's agreements can be seen as partially outside the estate, because the debtor must make the initial decision to either 'reject' or 'assume' each of its contracts and unexpired leases. If a debtor assumes a contract, the contract comes entirely into the estate and the debtor becomes bound by its terms. If a debtor rejects a contract, it commits a breach and the non-debtor party is left with a pre-petition claim for damages.[143] This power may have negative repercussions on the debtor's creditors. Roe and Adams note that whilst the automatic stay is intended to preserve going-concern value, the debtor's right to reject or assume contracts has incentives for the debtor to break up its portfolio of contracts along self-interested lines, keeping the winners and rejecting the losers. The debtor is obliged to pay in full contracts that it assumes. If it is presumed that the debtor will assume winning contracts, it means that it is paid in full value whilst it would only pay proportionately the rejected contracts. The debtor would thus maximise the value of the package to itself, at the same time preserving going-concern value.[144]

Impact of Close-out Netting under the Safe Harbours

In order to fully grasp the impact of the safe harbours, consideration should be given to the rationale for the bankruptcy law protection that it undermines. It was considered by Congress that the automatic stay gives companies attempting to restructure their debt under Chapter 11 'a breathing

140 EDWARDS & MORRISON (2005) 106.

141 11 U.S.C. § 362(a)(3). Since, as a general rule, secured parties are not listed in the exceptions of part (b) of this section, it is clear that the automatic stay applies to both unsecured parties, as to judgment liens, and secured parties, as to the repossession of collateral. See 11 U.S.C. § 362(a)(5). However, outright transfers of collateral appear to escape the provisions of the automatic stay if the transfer took place before the commencement of bankruptcy proceedings, they could be subject to the ninety-day suspect period unless the transaction qualifies under the safe harbours, *e.g.* as a repo transaction.

142 BAIRD & JACKSON (1984) 106.

143 11 U.S.C. § 365(a), (b)(1) & (g). See LUBBEN (2009) 66.

144 11 U.S.C. § 507 & 1129(a)(9). See ROE & ADAMS (2015) 384.

spell and time to work constructively with [their] creditors.'[145] According to Edwards and Morrison, by protecting the debtor's assets from creditors' individual actions, the stay 'avoids dismemberment of a firm with going-concern value and facilitates a collective proceeding in which the parties (debtor and creditors) can negotiate the terms under which the firm will continue as a going concern.'[146] Schwarcz notes that the safe harbours were not, in their current form, originally part of the Bankruptcy Code and became part of the Code, at least in part, through path dependence.[147]

It is not difficult to understand that the legislative treatment of the safe harbours is the antithesis of all that the two principles considered above stand for. The safe harbours promote the individual pursuit of claims and the seizing of collateral up to the eve of bankruptcy without the need to observe any suspect periods. This special treatment basically extends to the whole of the derivatives market on account of the wide definitions of swap agreements and on account of the blanket provisions of FDICIA. The negative effect of the treatment of close-out netting under the safe harbours on going-concern value and on debtor rehabilitation is easy to perceive. The exercise of close-out netting rights under the safe harbours therefore takes away the powers from the bankruptcy trustee to organise the rehabilitation or liquidation of the debtor and gives an unrestricted measure of self-help to the netting creditor to pursue its individual claims. The 'reject-and-assume' powers of the bankruptcy trustee are also rendered ineffective since the safe harbours transfer this power to the netting creditor who is given the option to exercise its close-out netting rights, which it is assumed will be exercised depending on whether closing out is favourable to itself.

Perhaps of a lesser impact is the exercise of close-out netting rights under resolution regimes. Thus, under FDIA the FDIC is empowered to stay individual creditor action for a limited period of sixty days,[148] but there is no general power to stay contracts. In particular, the FDIC cannot keep contracts in force while preventing counterparties from exercising their rights under those contracts. Thus, unlike bankruptcy courts, the FDIC cannot stay 'self-help' remedies such as liquidation of collateral, for most contracts. However, the FDIC as receiver has broad powers to disaffirm or repudiate contacts within a reasonable time.[149] As they cannot compel performance under the repudiated contract, the affected counterparty remedies are limited to *ex post* damages.[150] According to Bliss and Kaufman, unlike the general corporate bankruptcy stay that keeps contracts in place,

145 H.R. Rep. No. 595, 95th Cong., 2d Sess. 174 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6135.

146 EDWARDS & MORRISON (2005) 95.

147 SCHWARCZ (2015) 702. This aspect of path dependence will be discussed in the next part of this chapter.

148 12 U.S.C. § 1823(c)(2)(C).

149 12 U.S.C. § 1823(e)(1) & (2).

150 12 U.S.C. § 1823(e)(3).

this procedure is more akin to the close-out mechanism found in derivatives contracts.[151] When the FDIC unilaterally terminates a contract, it creates a claim that has the status of a general creditor. Thus, while most contracts, with the exception of QFCs, are automatically stayed by courts in the event of a corporate bankruptcy, the opposite situation obtains in the event of a bank's insolvency. It would thus seem that the exercise of close-out netting rights is more in tandem with the principles adopted by FDIA albeit with a temporary suspension on their applicability, than they are with the principles of the automatic stay and the 'assume-and-reject' powers enshrined in the Bankruptcy Code.

6.4.2 Effect of State Goals on US Insolvency Law

It is evident that the steps involved in a close-out netting process under US law, namely the termination of a financial contract, the exercise of set-off rights and the selling of collateral provided by the debtor to secure the contract are inconsistent with the broader goals of Chapter 11 of the Bankruptcy Code, such as debtor value maximisation, the rehabilitation of the debtor and equal treatment of creditors. The recognition of close-out netting provisions is also inconsistent with the scope of Chapter 7 liquidations insofar as concerns the priority ranking of creditors for the distribution of proceeds and the privileged position given to netting creditors. In this respect, Peck, Mokal and Janger explain that bankruptcy proceedings are designed to allocate loss from the insolvency in a predictable manner. The statutory priority regime, which according to these authors reflects the history of bankruptcy as it has developed in the US and the judgment of Congress as to the proper ranking of claims, is critical to achieve this by channelling losses away from creditors placed in a higher ranking to those placed in a lower one and is the model against which any deviations from the norm should be measured. Financial contracts, including close-out netting provisions inherent to these contracts, escape that measurement altogether by being excluded from the priority scheme applicable to all other creditors.[152]

The question to be considered in this part is whether the 'deviations from the norm' in relation to the privileged treatment of netting creditors under the safe harbours can be based on any public policy or state goals being pursued by Congress which could serve to justify them. In general, two principal reasons have been propounded for this special treatment. One is the traditional reason related to the need to prevent systemic risk associated with financial contracts. This is the reason propounded by Congress in relation to the various expansions of the safe harbours for which the exercise of close-out netting rights in relation to financial contracts was given

151 BLISS & KAUFMAN (2006a) 12.
152 PECK *et al.* (2011) 3.

special treatment.[153] The second reason, or rather 'non-reason' given its nature, is advanced by critics of the vast expansion of the safe harbours and relates to the notion of path dependency, implying that each safe harbour itself served as justification for the next safe harbour and as such was not tied to any 'conscious' public policy reason being pursued by Congress. Each of these reasons will be considered below.

One of the proponents of the systemic risk theory is Krimminger, former Senior Policy Advisor at the FDIC. Krimminger states that Congress expanded protection of the ability to terminate and set off claims under certain financial contracts 'because protection of these contractual rights is viewed as crucial to protect the viability, not only of individual counterparties, but of the marketplace as a whole.' Krimminger states that protected contracts must be actively traded in the financial markets and subject to the risks of fluctuating values inherent in those markets. For these reasons, he argues, Congress has repeatedly sought to protect participants and the markets 'from the delays inherent in normal bankruptcy processes and the impact this could have on values, liquidity, and access to pledged collateral.'[154] This proposal has been met with scepticism. After citing the various declarations made by Congress to justify the successive expansions of the safe harbours, Mooney notes that although most academics would agree that some special treatment for financial contracts is needed, it is commonly argued that the current treatment is 'far more generous than would be necessary to address the overarching goal of the safe harbors: the reduction or elimination of systemic risk.'[155] It has also been noted that since financial counterparties may simultaneously claim the debtor's assets upon filing for bankruptcy, there is a risk of a run on the debtor possibly leading to a liquidity shortage that has the potential to spill over to other firms and markets and cause widespread instability in financial markets.[156] The opt-out from the bankruptcy regime creates an opportunity for financial institutions to restructure standard financial contracts to look like derivatives agreements.[157] In other words, the safe harbours may merely substitute one kind of systemic risk for another.

153 Both the Bankruptcy Code safe harbours and FDIA focus on the systemic risk associated with financial contracts but whilst bankruptcy focuses on the 'risk to capital markets if financial contracts cannot clear too quickly', bank resolution focuses on bank runs, *i.e.* 'the danger of the contracts clearing *too* quickly.' See JANGER & POTTOW (2015) 156. Thus, whilst the Bankruptcy Code seeks to protect liquidity under certain instruments by exempting them from the automatic stay and avoidance powers, bank resolution law seeks to preserve the asset value of a bank by the transfer of its financial contracts to a solvent party.

154 KRIMMINGER (2006) 5.

155 MOONEY (2014) 251.

156 EDWARDS & MORRISON (2005) 105; FAUBUS (2010) 806.

157 KEATH HANCE (2008) 765.

The second reason given for the development of the safe harbours, and which is itself a form of criticism of the systemic risk theory, is that Congress followed a path dependency approach, whereby a preceding type of safe harbour served to justify later expansions without the legislator questioning the justification of the original safe harbour in the first place. Schwarcz and Sharon state that legal path dependence occurs 'when an initial path effectively blinds lawmakers to alternative paths.'[158] In such circumstances, it may be difficult to trace whether the development of the enforceability of close-out netting is the result of a conscious decision made by the legislator to pursue a defined public policy in the light of the applicability of US insolvency law. Scwarcz and Sharon note that the origin of the path dependence was the limited exemption, included in the bill that became the Bankruptcy Code, for the allegedly fragile commodities futures market. The untested justification for the initial exemption, namely concern about systemic risk, was reiterated by the President's Working Group on Financial Markets for subsequent expansions of the safe harbour, often without questioning the merits of the expansions to protect against systemic risk. According to Schwarcz and Sharon, this reflects an 'informational blindness', fuelled by both the complexity of derivatives and uncertainty over how systemic risk operates. Pressure was also brought to bear by powerful derivatives industry groups led by ISDA, whilst Congress was not presented with equally powerful opposing views.[159]

Mokal is another proponent of this path dependency theory. Mokal considers that this argument is without merit. He considers that in normal times, when markets are stable, close-out and asset realisation immunities are privately beneficial for individual counterparties who can terminate contracts and liquidate the collateral they hold in a value-preserving manner. By contrast, the simultaneous liquidation of significant quantities of contracts and of collateral triggers a collective action problem as contract and collateral values collapse. Mokal notes that in a path dependency approach, national policymakers are pushed down the favoured path through comparisons with sophisticated markets and through regional competitiveness considerations, leading to legislative changes with no necessary reference to either social welfare or fairness considerations.[160]

158 According to Schwarcz and Sharon, this blindness can occur when legislative patterns are locked in due to informational and political burdens. Informational burdens arise when the choice of one legislative course of action makes future assessments of alternative courses harder since policymakers become used to the 'normal' state of affairs. Political burdens are created when groups or institutions sympathize with earlier legislative choices and exert their influence to maintain the approach created by those choices. See SCHWARCZ & SHARON (2014) 1723.

159 *Ibid.* 1741. Schwarcz and Sharon note that the leading organisation that presented Congress with opposing views was the National Bankruptcy Conference. *Ibid.*

160 MOKAL (2015) 73.

It is important to bear in mind that the Congress was not specifically targeting the protection of close-out netting when establishing the safe harbours, rather Congress was protecting the exercise of contractual rights in relation to designated financial contracts. This makes it more difficult to understand the specific protection of close-out netting provisions in the light of the rationale of US bankruptcy law. Thus, close-out netting provisions are only protected if they form part of an eligible financial contract so that ordinary loans and other credit facility contracts which may also contain close-out netting provisions do not get any special treatment. It is also to be noted that specific focus on the protection of close-out netting rights started to be given in the 1990s by virtue of the enactment of sections 560 and 561 of the Bankruptcy Code, and of section 403 of FDICIA. This came at a time when the lobbyist movement led by ISDA was putting pressure on legislators to enact legislation protecting close-out netting provisions on the basis of party autonomy on the premise that, *inter alia,* this is required to curtail systemic risk.[161] There is little support for the systemic risk argument brought by Congress to justify the protection of the exercise of contractual rights under the safe harbours, in particular by the proponents of the path dependency theory. Adams notes that what drove Congress to create and expand the safe harbours is optimism about free markets, lack of understanding about complex new instruments and the fear of systemic risk.[162] When several financial crises finally drew attention to the derivative safe harbours in the early 2000s and particularly during the crisis of 2008, the emerging criticisms of the safe harbours also focused on systemic risk contributed by the safe harbours to the financial system by exacerbating the financial distress of major financial institutions and undermining market controls that might work to mitigate such distress.

6.5 Preliminary Conclusions

US law has been classified as an eclectic legal system, meaning that it bears elements of both the common and civil law systems. It also operates a dual system of state law and Federal law. The regulation of close-out netting is no exception to this legal set-up. Outside of a bankruptcy situation it is regulated wholly by the applicable state law. Within bankruptcy the applicable state netting law still applies but only within the confines of the mandatory provisions of the Bankruptcy Code. The US Bankruptcy Code has been generally classified as pro-debtor. This is reflected in various of

161 Schwarcz & Sharon refer to the leading role taken by ISDA in the drafting of the safe harbours, in particular its involvement in the drafting of BAPCPA and its close collaboration with the President's Working Group on Financial Markets. These authors also suggest that the derivatives industry proliferated, in part, on account of the US law safe harbours. See SCHWARCZ & SHARON (2014) 1741.

162 ADAMS (2014) 102.

its provisions, notably in its objective of giving the debtor a second chance and of preserving going-concern value for the benefit of the debtor by the adoption of principles such as the automatic stay. It gives the debtor the choice whether to file for rehabilitation or liquidation under the Bankruptcy Code and it normally entrusts the estate in the hands of the debtor.

Two main federal rules have been analysed which regulate the protection given to close-out netting provisions in an insolvency situation, namely section 560 of the Bankruptcy Code in relation to swap agreements and section 403 of FDICIA in relation to bilateral netting. Both provisions are clearly exceptions to the pro-debtor tendencies of US bankruptcy law. The protection of close-out netting under the US safe harbours forms part of the wider protection of contractual rights, a full list of which is provided in the definition of 'master netting agreement' in section 101(38A) of the Bankruptcy Code, and which apply in relation to widely-defined financial contracts concluded between financial participants. Not all safe harbours specifically cover this full list of protected rights. The initial safe harbours were intended to give protection to the close-out of contracts in order to crystallise open trading positions and did not stipulate the protection of contractual netting rights. It was only with the enactment of sections 560 and 561 that specific reference was made to off-set and netting in relation to the close-out of a financial contract. In order to solve the uncertainty created by the fact that not all safe harbours specifically refer to the protection of netting rights, section 403 of FDICIA was enacted to cover netting in relation to all the safe harbours, including those already covering close-out netting. This provision protects a close-out netting provision 'in accordance with its terms', reminiscent of the standard of protection under the EU's Financial Collateral Directive. However, it should also be noted that section 403 is made subject to a few exceptions, most notably to the powers of the FDIC to disaffirm or repudiate contracts under the FDIA regime[163] and under the OLA regime.[164]

It may be argued that prior to 1990 Congress did not have in mind the specific protection of close-out netting provisions. Indeed, the initial expansion of the safe harbours focused on specific and narrowly defined financial contracts where the focus was on closing out open positions, rather than reducing counterparty exposure through close-out netting. This is reinforced by the limited number of parties that originally benefited from the safe harbours, thus the recognition of close-out netting provisions was not foremost in Congress' mind. Considerations of recognition became more evident with the development of the derivatives market which relies on the enforceability of close-out netting provisions for its core functionality. It may be noted that section 560 of the Bankruptcy Code continues to refer to the exercise of close-out rights (in the form of termination, acceleration and liquidation) as separate from the exercise of netting rights, even though

163 12 U.S.C. § 1821(e).
164 12 U.S.C. § 5390(c).

netting under this section is specifically rendered enforceable in relation to termination, acceleration or liquidation. The separation of close-out from netting is even more pronounced in section 561 of the Bankruptcy Code which refers in the alternative to 'the termination, liquidation, or acceleration of *or* to offset or net termination values […]' when recognising the enforceability of master netting agreements. A counterargument to this is that the reference to 'or' may be more cosmetic than consequential since the netting is of 'termination values' and hence presupposes that a termination has already taken place.

Of a different category is the bilateral netting provision of section 403 of FDICIA which is possibly unique in focusing solely on the recognition of netting arrangements concluded between financial institutions, as opposed to the safe harbours which recognise close-out and netting as part of other contractual rights which have been granted special protection. In this case the law speaks of contractual payment obligations and contractual payment entitlements which are 'terminated, liquidated, accelerated, *and* netted', thus indicating that these elements are considered as part of the same single contractual mechanism. This provision grants virtually full recognition to close-out netting provisions within its scope of application, evidenced by the reference to 'in accordance with, and subject to the conditions of, the terms of any applicable netting contract.' Although the scope of application of this provision is wide and covers any contract concluded by defined financial institutions, it does not cover contracts concluded between parties, at least one of whom is a non-financial institution.

First Sub-question

It has been argued that it is difficult to consider the right of netting protected under the safe harbours as a mere contractual enhancement of ordinary set-off. Contrary to the law regulating netting, the exercise of ordinary set-off rights remains, to a significant extent, subject to the insolvency law principles and may only be exercised within the confines of section 553 of the Bankruptcy Code, the most notable restriction being that both claims should have arisen pre-petition and, for certainty sake, before the ninety-day suspect period. Any variations from the confines of section 553 require the approval of the courts. It is arguable that the concept of insolvency close-out netting may have little in common with that of ordinary set-off rights, except for the fulfilment of the mutuality requirement, and may have developed as a completely separate concept based as it is on the notion of protection of contractual rights in relation to financial contracts. Thus, whilst all insolvency principles and restrictions still apply to ordinary set-off unless the exceptions of section 553 of the Bankruptcy Code apply or unless the set-off is allowed through court intervention, the exercise of contractual close-out netting rights under the safe harbours is exonerated from observance of these principles or restrictions, save when exercised in bad faith.

Court intervention is also still prevalent for the exercise of ordinary set-off rights and is particularly crucial if the rights subject to set-off have arisen on the eve of bankruptcy or post-bankruptcy. Court intervention is also required to facilitate the ordinary set-off process where the requirements of maturity or liquidity of obligations have not been fully met, but where an estimation by the court is possible. On the other hand, if close-out netting arrangements set out the contractual modalities for calculating close-out amounts, then these will be enforceable when exercising close-out netting rights under the safe harbours without the need to resort to the courts for an estimation and without the need to observe any suspect periods. The preliminary conclusion in relation to the first sub-question raised in the Introduction is therefore that close-out netting under US law does not stem from ordinary set-off but has been created as a separate concept, possibly to suit the requirements of the derivatives market industry. This conclusion will be examined further in Part III.

Second Sub-question

It is not difficult to envisage that the safe harbours are an exception to the traditional rationale of US bankruptcy law which is aimed towards the discharge of the debtor and the preservation of the going-concern value of the enterprise, even if more recent developments have seen a shift in maximising creditor recoveries through the pre-pack option. Criticism has been levelled at the idea that the safe harbours are required to protect against systemic risk. Indeed, the FDIA and OLA resolution regimes were, in part, put in place to combat the systemic risk potentially arising from the individual credit resolution regimes and to impose restrictions aimed to achieve a more equitable balance between the protection of creditors' claims and the pursuit of goals such as market stability and the protection of depositors. Because it is difficult to justify the remaining safe harbours on grounds of systemic risk, the path dependency theory has gained popularity among academic circles which fail to accept that Congress could justify each expansion on the basis of systemic risk, but who conclude that each expansion was itself used as justification for subsequent expansions on the basis of what has been termed informational blindness. In the end and as a preliminary conclusion of the second sub-question, it may be difficult to reconcile the protection given to close-out netting under the safe harbours in pursuit of a particular goal or public policy followed by Congress which, except in relation to the application of resolution regimes, has chosen to give virtually full protection to close-out netting from the application of insolvency law principles.

Third Sub-question

The financial crises in the US heralded new considerations of systemic risk and led to the adoption of two resolution regimes, first the FDIA regime for insured banks and subsequently the OLA regime for systemically important non-bank financial institutions. A primary goal of these resolution regimes is to promote the stability of the financial system by preventing market contagion. They therefore impose brief stays on early termination rights that would otherwise be triggered by the commencement of receivership or conservatorship. These brief stays are intended to stop a run on banks and preserve the value of the assets of the systemically important institution for the benefit of the institution's stakeholders and the economy in general.

Resolution measures have brought mixed effects on the exercise of close-out netting rights. The FDIA regime applicable to banks has had the effect that banks are no longer subject to the ordinary bankruptcy regime and close-out netting rights pertaining to banks are exercisable only under the provisions of FDIA. Under FDIA the exercise of close-out netting rights may be temporarily suspended to allow for the taking of resolution measures whilst partial transfer of QFCs are prohibited. The same restriction and safeguard apply in relation to systemically important non-bank financial institutions under the OLA regime although in this case a determination of the systemic importance of the institution has to take place before the FDIC may exercise its powers in relation to close-out netting provisions. The type of brief stays imposed on close-out netting provisions and the restriction on partial transfers are reminiscent of the type of restrictions or safeguards imposed under the English and French regimes. One difference is the bail-in regime which appears to operate differently in the US. A detailed comparative analysis of the impact of the resolution regimes of the three selected jurisdictions on close-out netting provisions will be made in Chapter 7.