I. Background Example -- Safe Harbors and SIFIs under US Law

At least since 1982, in the US, it has been recognized that the safety and soundness of the financial services sector and bankruptcy law are closely intertwined. On the banking side, concern about contagion and bank runs, often associated with economic downturns, dates back to the Great Depression and before. On Main Street, the financial stability of ordinary operating companies can have significant effects on the economy at large and reverberations for the financial system as well. When the Penn Central railroad failed in 1970, the commercial paper market froze.\(^1\) Chrysler was bailed out in 1979, at least in part, because of fear that the failure of a large industrial enterprise might adversely affect the economy and the financial system generally. In short, events with significance for the financial system can originate either in the financial sector, or in the regular economy. The dividing lines are not perfectly distinct.

In the US, these related concerns are handled by two distinct legal architectures – one for banks and one for ordinary businesses. Concerns about bank failure and bank runs are handled by the FDIC and other bank regulators, while failure or reorganization of non-banks is handled through bankruptcy. This division has remained, even though some financial firms are not banks and the failure of non-financial firms can have systemic effects. These systemic effects may arise because of a firm’s sheer size, or because a firm’s business overlaps with the financial services sector, for example, through a large financing subsidiary.\(^2\) We offer the US as an example because the US experience has informed the current discussion, and because the development of


\(^2\) As we will discuss below, this same bifurcation is retained by the current international instruments that address systemic risk. The IMF/World Bank ICR ROSC Assessment Methodology, UNCITRAL Legislative Guide, and UNIDROIT Principles on Closeout Netting focus on the insolvency in the ordinary economy, while the FSB Key Attributes for Effective Resolution of Financial Institutions focus on the failure and resolution of financial institutions.
existing international standards, as they apply in insolvency, has its roots in the US approach.³

Since 1978, a number of adjustments have been made to the ordinary bankruptcy regime to accommodate the needs of financial institutions. The first generation of accommodation was embodied in a series of provisions exempting certain types of financial contracts from the automatic stay and avoidance.⁴ These so-called “safe harbors” or “immunities” were incorporated into the Bankruptcy Code, first in the 1980s, and then expanded significantly in 2005. They are also reflected in the current IMF/World Bank Insolvency and Creditors’ Rights Regimes ROSC Assessment Methodology discussed below. The articulated concern that motivated the safe harbors was clearance or intermediary risk – a broker dealer or other financial intermediary might fail, and the automatic stay and avoidance powers might disrupt the clearance and confidence in securities markets. When the safe harbors were first added to the Bankruptcy Code in 1982, the House Report stated:

The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes volatile nature [of] the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market. (emphasis added)(H. Rep. No. 97-420, at 1–2 (1982), reprinted in 1982 U.S.C.C.A.N. 583, 583.)

This quotation does not reflect a concern with so-called “Too Big To Fail” or “systemically significant” financial institutions. Quite the contrary, the paradigmatic institution was assumed to be not too big to fail. The failure of the intermediary itself was not expected to have systemic effects. Instead, the concern was with the effect of certain bankruptcy rules on trading and clearance within certain financial product markets. The resulting adjustments to the Bankruptcy Code reflected a desire to preserve the liquidity of securities markets, even at the expense of the insolvent firm itself -- which would likely be liquidated under SIPA -- and the firm’s non-financial creditors.

These adjustments took two forms. First, certain transactions were exempted from the automatic stay, so: (1) “ipso facto” or “termination” clauses could be enforced upon

³ Compare 11 U.S.C. 363(b), 546(e) with recommendation 101-107 of the UNCITRAL Legislative Guide on Insolvency.
⁴ Stockbroker-Commodity Broker Amendments to the Bankruptcy Code Pub. L. 97-222, 96 Stat. 235 (1982). See also, In Re Grafton Partners, 321 B.R. 527 (2005)(Klein, J.)("Public Law 97-222 was a package of amendments designed to protect the carefully-regulated mechanisms for clearing trades in securities and commodities in the public markets from [the] dysfunction that could result from the automatic stay and from certain trustee avoiding powers.".
bankruptcy, (2) obligations arising out of transactions between counterparties could be set-off on an aggregate basis ("netted"),\(^5\) and (3) any collateral securing the contract or contracts could be sold.\(^6\) Collectively, these three features are often referred to as “close-out netting”, but really there are three steps: termination, setoff, and sale of collateral. Second, these same transactions were treated as final, and exempt from preference or other later avoidance for any reason other than intentional (or “actual”) fraud.

The cumulative effect of these provisions is to allow certain creditors to make themselves whole notwithstanding bankruptcy, while reducing the distribution to other claimants. More importantly, the financial assets that are subject to netting would otherwise be available for use by the debtor, in the form of cash collateral.\(^7\) Hence, the safe harbors have two second-order consequences. They prefer one set of creditors over others, and they reduce the debtor’s available cash, thereby limiting or eliminating the possibility for successful reorganization or going concern sale.

The 2008 financial crisis and the collapse of *Lehman Brothers* prompted a second set of adjustments at the intersection of the bankruptcy and bank resolution regimes. The FDIC and US bank regulators follow a different approach to bank insolvency than the Bankruptcy Code follows for non-banks. Banks largely hold financial assets, rather than hard assets. Because these assets are liquid and the value is not directly linked to the bank’s business operations, the practice is to quickly divide the failed bank into two pieces, a good bank (containing performing assets and assets with readily ascertainable value), and a bad bank (containing non-performing or illiquid assets). The performing assets are then sold to another financial institution, while the non-performing assets are transferred to the government. The key differences are (1) that unlike bankruptcy, which may take a while, these “bridge bank” transactions are generally accomplished in two business days (plus a weekend); (2) there is no exemption or “safe harbor” for financial contracts. Indeed, as discussed below, the failure of the bank is not treated as a termination event for a financial contract. Neither is the transfer of the financial contract to another financial institution. In short, netting is stayed for two days (or so) and then resumes in the ordinary course once the financial contract is transferred, but no “termination” or “closeout” occurs.

Significantly, the focus of the bank resolution regime is not contagion as a result of lost liquidity due to the failure of particular transactions to clear immediately -- what we

---

\(^5\) Many derivative counterparties who engage in repeated or multiple transactions conduct their affairs pursuant to a master netting agreement that provides for contract based netting rights. This is one way in which closeout netting, in this context, has a more extensive ambit than standard setoff rights arising by operation of law in many legal systems. Indeed, some master netting agreements include within their scope transactions with third parties as well.

\(^6\) The current safe harbors can be found at 11 U.S.C. §§ 362(b) 6, 7, 17, 27, 546(e), (f), (g), 555, 556, 559, 560 and 561.

\(^7\) 11 U.S.C. § 363(c).
have called “intermediary” or “clearance” risk. The concern is that the failure of one institution may have an effect on its counterparties directly. This is sometimes referred to as “counterparty risk” or “Too Big To Fail” risk.

Lehman demonstrated the mismatch between the competing approaches to these two distinct types of systemic risk.\(^8\) Lehman and other investment banks do not take customer deposits, so they were not under the jurisdiction of the FDIC. As an investment bank, however, many of Lehman’s assets and liabilities fell into the “safe harbored” category. With no bankruptcy stay and no two-day stay, the early termination of financial contracts proved a serious problem in maximizing the value of Lehman’s assets.\(^9\) More specifically, while a sale to Barclay’s was in the works, the absence of a bankruptcy stay meant that a regulatory delay in the UK made it impossible to complete a going concern sale. The consequences of Lehman’s disorderly failure are still being felt.

The legislative response to Lehman’s failure took the form of Title II of the Dodd-Frank Bill.\(^10\) Dodd-Frank expanded the FDIC’s jurisdiction to include systemically significant financial institutions or “SIFI”s. In other words, large non-bank financial institutions were removed from bankruptcy jurisdiction, and hence from the scope of the safe harbors. They were instead subjected to the bank resolution regime to be governed by the Orderly Liquidation Authority.

Even after Dodd-Frank, the regimes for treatment of financial contracts remain divided between the bank resolution regime -- focused on limiting contagion caused by the failure of a systemically significant counterparty, and the ordinary bankruptcy regime -- focused on isolating clearance or intermediary risk caused by the failure of a systemically insignificant intermediary. The risks are not identical, and the approaches followed in the two systems sometimes work at cross-purposes. As Lehman illustrated, because of its size, the possibility of Lehman defaulting on its own contracts had systemic risk implications. It appears that protecting the early termination and netting rights of Lehman counterparties may have actually increased counterparty risk, because Lehman was then unable to honor its other contracts. The ensuing panic nearly “broke the buck,” endangering the securities in money-market mutual funds that were axiomatically supposed to trade at par.\(^11\) Where the counterparty is systemically significant, the perceived imperatives of the two systems must be balanced against each other and perhaps reexamined. This inconsistency was reduced by Dodd-Frank but not entirely eliminated.

---

\(^8\) Kenneth Ayotte and David A. Skeel Jr., Bankruptcy or Bailouts, 35 Journal of Corporation Law 469 (2010).
\(^9\) Mark Roe and Stephen Adams, Restructuring Financial Firms in Bankruptcy: Lessons from Lehman (on file with authors).
\(^10\) Dodd-Frank: Title II - Orderly Liquidation Authority, H.R. 4173, 111th Cong. (2010).
A number of post-2008 international instruments similarly recognize some of the interactions between bankruptcy and bank resolution and moderate their effects (see the discussion of post-crisis developments, below). As we will discuss in the next section, however, the World Bank’s *Principles for Effective Insolvency and Creditor/Debtor Regimes* (“the World Bank Principles”) that are used as the basis for assessing general enterprise insolvency and creditor/debtor regimes (ICR) regimes have not yet taken these developments into account.

II. Treatment of Financial Contracts in Insolvency and the World Bank ICR ROSC Initiative

The World Bank currently evaluates the insolvency and creditors’ rights regimes (“ICR”) of many countries as part of the IMF/World Bank ROSC (Report on the Observance of Standards and Codes) Initiative. The ICR ROSC Assessment Methodology is based on the World Bank Principles together with the UNCITRAL Legislative Guide’s recommendations. The Principles and the Guide’s Recommendations together constitute the international “best practice standard” for insolvency regimes (the “ICR Standard”). The ICR Standard is one of twelve such standards recognized by the Financial Stability Board to be “broadly accepted as representing minimum requirements for good practice that countries are encouraged to meet or exceed” and whose implementation is “key for sound financial systems and deserving of priority implementation depending on country circumstances”.

The ICR Standard prescribes special treatment for financial contracts, consistent with the “safe harbor” approach developed under the US Bankruptcy Code. Indeed, the standard was put in place prior to the financial crisis of 2008 and the associated worldwide adjustments to financial regulation.

For most contractual obligations the ICR Standard prescribes a general approach that prohibits (“stays”) termination of executory contracts pending the debtor’s decision whether to assume (perform) or reject (breach) the contract. They then provide an exception to this rule for “financial contracts” that tracks the safe-harbor approach followed under US Law. World Bank Principle C10.4 of the ICR Standard provides:

C10.4 Exceptions to the general rule of contract treatment in insolvency proceedings should be limited, clearly defined, and allowed only for compelling commercial, public, or social interests, such as in the following cases: (i) *upholding general setoff rights*, subject to rules of avoidance; (ii) *upholding automatic termination, netting, and close-out provisions contained in financial contracts*; (iii) preventing the continuation and assignment of contracts for irreplaceable and personal services where the law would not require acceptance of performance by another party; and (iv) establishing special rules for treating employment contracts and collective bargaining agreements. (emphasis added)
The Legislative Guide’s recommendations provide additional specific guidance. Recommendation 71 would exempt financial contracts from the stay of termination. Recommendation 100 preserves set-off rights that exist outside of bankruptcy (though subject to the stay, and avoidance). Recommendations 101-107 apply specifically to financial contracts and provide:

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

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

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

104. The insolvency law should specify that routine pre-bankruptcy transfers consistent with market practice, such as the putting up of margin for financial contracts and transfers to settle financial contract obligations should be exempt from avoidance.

105. The insolvency law should recognize and protect the finality of the netting, clearing and settlement of financial contracts through payment and settlement systems upon the insolvency of a participant in the system.

106. Recommendations 101 to 105 should apply to all transactions that are considered to be “financial contracts,” whether or not one of the counterparties is a financial institution.

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

(emphasis added)

In short, the current ICR Standard is based on a broad definition of “financial contracts,”
the right to immediate termination and netting of financial contracts, and finality of the transfers associated with performance and clearance of those financial contracts. The focus of the Standard seems to be on ensuring the clearance of financial contracts, regardless of their effect on the prospects for a particular company’s reorganization, going-concern sale or orderly/coordinated liquidation.

III. Post-Crisis Developments and Subsequent International Instruments

Since the 2008 crisis, there have been significant developments in thinking about the proper approach to systemic risk in the financial system. In the US, this was manifested through the enactment of Title II to the Dodd-Frank Bill discussed above. At the international level, the Financial Stability Board and UNIDROIT have reevaluated the appropriate framework from a post-crisis perspective.

Under these newer standards, preservation of liquidity remains important, but the scope of the recommended safe harbors has been narrowed to focus more tightly on intermediary risk, reaching only transactions where a financial institution is actually involved. With regard to counterparty risk, by contrast, the focus has been expanded beyond resolution of banks to include other systemically significant financial institutions.

a. FSB Key Attributes

The Financial Stability Board has published a list of “Key Attributes” for resolution of financial institutions. The approach to netting tracks the FDIC regime described above, not the bankruptcy regime:

4. Set-off, netting, collateralisation, segregation of client assets

4.1 The legal framework governing set-off rights, contractual netting and collateralisation agreements and the segregation of client assets should be clear, transparent and enforceable during a crisis or resolution of firms, and should not hamper the effective implementation of resolution measures.

4.2 Subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the

---

12 It should be noted that the World Bank Principles are silent with regard to insulating financial contracts from avoidance. Legislative Guide Recommendation 104, (and US Law), by contrast, specially protect the finality of payments under those contracts.
contract continue to be performed.

4.3 Should contractual acceleration or early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers. The stay should:

(i) be strictly limited in time (for example, for a period not exceeding 2 business days);

(ii) be subject to adequate safeguards that protect the integrity of financial contracts and provide certainty to counterparties (see Annex IV on Conditions for a temporary stay); and

(iii) not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to entry into resolution or the exercise of the relevant resolution power occurring before, during or after the period of the stay (for example, failure to make a payment, deliver or return collateral on a due date).

The stay may be discretionary (imposed by the resolution authority) or automatic in its operation. In either case, jurisdictions should ensure that there is clarity as to the beginning and the end of the stay.

4.4 Resolution authorities should apply the temporary stay on early termination rights in accordance with the guidance set out in Annex IV to ensure that it does not compromise the safe and orderly operations of regulated exchanges and FMIs.

Thus, unlike the “safe harbor” approach used in bankruptcy (i.e. in general enterprise insolvency), commencement of the resolution of a financial institution is not a basis for early termination of financial contracts. Even if termination is provided for by contract, such termination is stayed for a short period. The purpose of the stay is to permit the resolution authority to arrange for a transfer of assets to another solvent financial institution.

Such a transfer would accomplish nothing if upon transfer of the assets the contracts were still subject to early termination, so upon transfer, the termination of financial contracts is further stayed:

Transfer of assets and liabilities

3.3 Resolution authorities should have the power to transfer selected assets and liabilities of the failed firm to a third party institution or to a
newly established bridge institution. Any transfer of assets or liabilities should not:

(i) require the consent of any interested party or creditor to be valid; and

(ii) constitute a default or termination event in relation to any obligation relating to such assets or liabilities or under any contract to which the failed firm is a party (see Key Attribute 4.2).

In short, unlike the bankruptcy safe harbor regime that contemplates immediate termination, netting and protection of finality notwithstanding insolvency, the regime proposed by the FSB Key Attributes contemplates preservation of netting rights, but if all works as planned, premature termination and netting will not occur, and neither will any market disruption (beyond the two day delay).

b. **UNIDROIT Principles on the Operation of Close-out Netting Provisions**

UNIDROIT has similarly developed a set of principles on close-out netting for financial contracts. While the FSB Key Attributes apply only to close-out netting in the context of financial institution resolution, the UNIDROIT principles provide guidance on the operation of close-out netting generally, including their operation in insolvency, and in this respect they are designed also to apply to the insolvencies of entities that are not financial institutions. While the two sets of principles can be reconciled (discussed below), there are some potential differences in approach.

The UNIDROIT principles’ approach to close-out netting treatment in enterprise insolvency is similar to the Legislative Guide and World Bank Principles in that they advocate respect of close-out netting provisions in financial contracts. They are narrower than either, however, in several respects:

- As a suggested minimum standard, the definition of financial contract is limited to those contracts where one of the parties is a financial institution or public authority.

- They take account of the possibility that the domestic law will impose a stay on termination of financial contracts in the context of its bank resolution regime.

- Neither the Key Attributes nor the UNIDROIT Principles address issues relating to sale of collateral or insulation from later avoidance as a
preference or constructive fraudulent conveyance.13

Principle 1 defines the scope of the Principles as limited to transactions where at least one party is a financial institution or central bank. It states that the Principles, “deal with the operation of close-out netting provisions that are entered into by eligible parties in respect of eligible obligations.” “Eligible parties,” include any person who is not an individual engaged in a consumer transaction. “Eligible obligations,” are defined in Principle 4 as any of a wide variety of financial contracts where at least one party is a “qualifying financial market participant” or “public authority.” Those terms are defined in Principle 3 as follows:

(2) ‘Qualifying financial market participant’ means any of the following:
(a) a bank, investment firm, professional market maker in financial instruments or other financial institution which (in each case) is subject to regulation or prudential supervision;
(b) an insurance or reinsurance company;
(c) an undertaking for collective investment or an investment fund;
(d) a central counterparty or a payment, clearing or settlement system, or the operator of such a system which (in each case) is subject to regulation, oversight or prudential supervision;
(e) a corporation or other entity that, according to criteria determined by the implementing State, is authorised or supervised as an important participant in the implementing State’s markets in contracts giving rise to eligible obligations.

(3) ‘Public authority’ means any of the following:
(a) a governmental or other public entity;
(b) a central bank;
(c) the Bank for International Settlements, a multilateral development bank, the International Monetary Fund or any similar entity.

For transactions covered by the Principles, early termination and closeout of the transaction would not be stayed.

PRINCIPLE 7
Operation of close-out netting provisions in insolvency and resolution
(1) Subject to Principle 8 and in addition to Principle 6, the law of the implementing State should ensure that upon the commencement of an insolvency proceeding or in the context of a resolution regime in relation to a party to a close-out netting provision:
(a) the operation of the close-out netting provision is not stayed;

13 Though, under World Bank Principle 7.1(c) the act of netting post-petition, pursuant to the safe harbor would not, in and of itself, be a basis for avoidance.
(c) the mere entering into and operation of the close-out netting provision as such should not constitute grounds for the avoidance of the close-out netting provision on the basis that it is deemed inconsistent with the principle of equal treatment of creditors;

... However, under principle 8, if there is a stay under the nation’s bank resolution regime, that stay would still apply with regard to the insolvency of the financial institution.

Thus, if the debtor is a financial institution, a short stay will likely apply to its financial contracts when it is resolved, but if the debtor is a non-financial institution that has entered into a financial contract with a financial institution, the netting of the transaction will not be stayed. There is, thus, an asymmetry of treatment contemplated by the UNIDROIT Principles that safe harbors derivatives when they are an asset held by a financial institution and the debtor is not subject to the bank resolution regime. A short stay, however, is likely to apply and termination is likely to be foreclosed when it is the bank itself that fails.

c. **Comparison of ICR Standard to the Key Attributes and UNIDROIT Principles**

The discussion above demonstrates that there are a number of major inconsistencies between the existing ICR Standard and the newer Key Attributes and UNIDROIT Principles.

- First, under the UNIDROIT Principles, the safe harbor only extends to transactions where at least one of the counterparties is a financial institution or central bank (a “Qualified Financial Market Participant”). By contrast, the ICR Standard does not have such a limitation on the nature of the parties but instead applies to financial contracts generally (and by reference to the Guide, it encompasses existing financial contracts and would accommodate new types of financial contracts as they appear).

- Second, under the FSB Key Attributes, closeout netting may be stayed for a short period to facilitate the transfer of financial contracts to a solvent financial institution. The UNIDROIT Principles similarly contemplate that close-out netting may be stayed, if only for a short time, if such a stay exists under the nation’s bank resolution regime. The ICR Standard excludes the operation of termination and ipso facto clauses in financial contracts from the stay with no exceptions.

- Third, as noted above, the FSB Key Attributes and UNIDROIT Principles do not

---

14 Though UNIDROIT Principle 4.2(a) contemplates (though it does not recommend) that a country might choose to expand the scope eligible transactions beyond those where at least one of the parties is a Qualified Market Participants.
speak to an immediate right to seize and/or sell collateral. By contrast, the ICR Standard permits unfettered sale of collateral subsequent to close-out netting. The short stay and suspension of termination rights upon transfer, contemplated by the FSB regime and incorporated by reference into the UNIDROIT Principles seem in tension with this recommendation.

These differences suggest a possible need to conform the ICR Standard to emerging international best practice, particularly in light of the newer instruments. Issues for consideration include, (1) the desirability of limiting the scope of the safe harbors to situations where one of the counterparties is a financial institution or central bank; (2) which financial contracts need to be safe harbored and why; (3) whether the newer international instruments themselves should be harmonized with regard to a short stay and/or limiting termination rights for a short period to facilitate the transfer of financial contracts to a solvent counterparty.

IV. Additional Concerns: Undermining the General Enterprise Insolvency Regime

Another problem that has emerged under the existing safe harbor regimes, and that may require consideration, is that the broad inclusiveness of the immunities has invited misuse of safe harbor provisions and risked making the bankruptcy regime ineffective. A number of examples from the US illustrate the problem. The term “settlement payment” is broadly defined under US law. For example, in Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., the Second Circuit held that the redemption of commercial paper was insulated from avoidance as a preference (long after the firm’s failure) because it fell within the safe harbor as a “settlement payment.” This was true, even though Enron was not a financial institution, and the recipient of the payment was the true party in interest. In other words, the safe-harbor insulated a naked preference from avoidance years after the financial crisis had passed. This raises the possibility that transactions might be structured to fall within the safe harbors to take advantage of the bankruptcy exemption, regardless of whether the transaction has any systemic risk implications whatsoever. In In re McMenamin’s Grill Judge Drain raised this concern and held that a transfer of ownership to a bar and grill through the use of stock was not safe harbored because no intermediary was involved. As Judge Peck pointed out in Quebecor, however, it is not clear that, after Enron, McMenamin’s Grill is still good law.

This broad definition of the safe harbors has unintended collateral consequences for the

15 651 F.3d 329 (2d Cir. 2011).
bankruptcy process. This collateral damage takes two forms. The first relates to the exception from the automatic stay and the second relates to the insulation of these safe harbored transactions from avoidance.

a. Risks of Cash Crunch

Under a broad immunities regime such as that currently contemplated by the ICR Standard, many of the instruments that would be safe harbored, and therefore subject to immediate termination would otherwise constitute “cash collateral” in a bankruptcy, available for use in the business. One example would be a repurchase agreement, where the underlying collateral was money, or money-like. The effect of the safe harbor, at the time of bankruptcy, may be to deplete the cash available to the debtor to otherwise bridge the debtor to a value preserving going concern sale or rescue. Certain types of collateralized debt instruments (for example, government security repurchase agreements) play an important role in the economy as cash substitutes. In such cases, the need for these instruments to behave like currency may outstrip the bankruptcy policy at issue. However, the current ICR Standard and the law in the US include many instruments where the link to monetary policy or any other systemic justification is much weaker. Under the current formulation, for example, they could be read to cover stock used as collateral in a purely “mom and pop transaction”, or the investment certificates issued by Bernie Madoff in connection with his Ponzi scheme.

The consequence is that debtors whose capital structure includes a large number of safe harbored instruments (whether or not those instruments or the debtor itself are systemically significant) will be unable to use bankruptcy to preserve value for other investors and the larger economy. The Lehman bankruptcy provides an illustration of this problem, and while Title II of Dodd-Frank would have altered the effect in Lehman, the problem remains for smaller financial institutions and other debtors who, by themselves, are not systemically significant. In short, the safe harbors may be most likely to destroy value precisely when they are not needed – when the debtors involved are not systemically significant. Worse yet, where the debtor is systemically significant, they are likely to accelerate contagion, because the consequences of the rapid failure of a large institution will be impossible to contain.

b. Risk of Insulation of Preferences and Fraudulent Conveyances

As noted above, one consequence of a broad definition of financial contracts is that an avenue is created that allows private parties to structure transactions to fall within the safe harbors regardless of whether they have systemic risk implications. Examples are the terms “settlement payment”, “securities contract” and “financial contract” as defined under US Law. In cases like Enron, Quebecor and Madoff, cited above, purely

18 See text at notes 16 an 17 supra.
private non-intermediated transactions among systemically insignificant parties, which would otherwise be avoidable as preferences or fraudulent transfers, were safe harbored. In these cases, the impact of the safe harbor was not to allow transactions to clear in the midst of the financial crisis, or to preserve the finality of payments through intermediaries, but instead to insulate preferential or fraudulent payments made on the eve of bankruptcy from avoidance even if the financial institutions involved had little or no economic stake in the transaction.

This protection of finality is recommended as part of the ICR Standard, but is not an element of the UNIDROIT Principles. It is a protection that makes sense in the context of the failure of a small broker dealer who was merely clearing the transaction, but not where the recipient of the payment is the ultimate beneficiary. Consideration should be given to whether the safe harbor provisions should apply to these non-systemic transactions, especially if no intermediary was involved. The threshold for safe harbored treatment should require, at the very least, some level of systemic significance for the transaction.

Conforming the ICR Standard to the UNIDROIT Principles, for example, might eliminate this anomaly to some extent. Limiting the scope of the safe harbors to transactions where at least one party to the underlying transaction is a Qualified Financial Market Participant would solve the problem where the use of a bank account or a brokerage account is incidental to a transaction between non-financial parties. It would not eliminate the fact that this approach gives preferred treatment to banks in routine financing transactions with no systemic risk implications, such as a restaurant chain closing out a routine repo with a bank, or providing additional collateral for a loan related to a securities contract.

V. Additional Concerns: Lack of Symmetry as an Obstacle to International Harmonization

The discussion above shows that the bankruptcy and bank insolvency regimes handle financial contracts differently. This difference of treatment might be path dependent, but the asymmetry between the bankruptcy and bank insolvency treatment of financial contracts can create a variety of problems.

- There may be uncertainty as to which regime is applicable.
- There may be uncertainty about how an instrument will be treated.

20 There been a longstanding debate with regard to bankruptcy whether a debtor and a particular creditor can agree in advance to exempt a transaction from a possible future bankruptcy. See, e.g., Robert K. Rasmussen, Debtor’s Choice: A Menu Approach to Corporate Bankruptcy, 71 Tex. L. Rev. 51 (1992). This concept of “bankruptcy remoteness” is controversial, and it is most decidedly not the purpose of the existing safe harbors.
• When one is making recommendations for harmonization across national boundaries the underlying regulatory structures may differ. Many nations have separate regimes for bank resolution and for the winding up or reorganization of non-financial firms. This separation is not universal. Some countries use the same insolvency regime for all firms. Where this is the case, it may not be possible, as a practical matter to operate the two distinct regimes in tandem.

• Even where a nation maintains distinct bankruptcy and bankruptcy resolution regimes, it may not always be clear which regime is applicable to a particular firm. For example, in the United States, the Department of the Treasury has provided a list of systemically significant financial firms whose failure will be governed by the Dodd-Frank orderly liquidation regime. However, the Orderly Liquidation Authority's jurisdiction is not limited to those firms, so it is possible that a firm may discover on the eve of its failure that it has suddenly become subject to a different insolvency regime.

• Other problems may appear where a corporate group is made up of both bank and non-bank subsidiaries. Thus, asymmetric treatment of financial contracts might have practical consequences.

VI. Additional Concerns – Clearinghouses

Since the enactment of the safe harbors in the US and the adoption of the ICR Standard, another development has altered the landscape. Clearinghouses have emerged as an institution for clearing a wide variety of derivatives.21 These clearinghouses maintain their own margin rules, and are therefore designed to limit the clearance risk associated with the failure of a single market participant. This may limit the cost and risk associated with a short delay in close-out netting. On the other hand, there may still be situations where a failing institution is so large that the clearinghouse may be inadequate to absorb the failure. This should only happen in cases like Lehman, and these are precisely the case where it has been shown that the safe harbors may lead to value destruction (through early termination), and, as discussed above, may actually increase rather than reduce contagion. It is not clear precisely how this development plays into the discussion, but on its face, it would appear to reduce the need for, or at least limit the necessary scope of the safe harbors within bankruptcy.

VII. Commentary on the safe harbors

The events of 2008 have led to extensive policy and academic discussions. Annex I of this discussion paper delineates some of the key approaches discussed in the literature for addressing the perceived problems associated with the safe harbors. The Annex does not intend to express an opinion as to the advisability of any of these approaches, but it lists and summarizes them for background.

VIII. Issues for consideration

In view of the discussion above, consideration may be given to the following questions:

• Does the ICR Standard on the treatment of financial contracts in insolvency require revision? Or should it remain as it is?

• Should the ICR Standard be rewritten to conform to the FSB’s Key Attributes and/or the UNIDROIT Principles?

• Can the current ICR Standard address the diversity of transactions, parties, and insolvency law/resolution regimes?

• Are there specific changes that should be recommended?
  o Does the ICR Standard cover too many types of financial contracts?
  o Should its scope be limited to transactions where one party is a bank, financial institution or public authority?
  o Should the ICR Standard conform the types of financial contracts and parties covered to those covered by the UNIDROIT Principles?
  o Should the ICR Standard be narrowed to address close-out netting only, without reference to finality or avoidance?
  o Should the current approach to immediate seizure and sale of collateral be maintained?
  o Should the ICR Standard suggest a symmetric approach, i.e. one that would align the treatment of financial contracts in an enterprise insolvency context with their treatment in financial institutions resolution context?
Annex I

This Annex summarizes the key policy proposals addressing the existing safe harbors, along with their key academic proponents, and relates them to the instruments analyzed in the main paper and the ICR Standard.

I. Narrow the Safe Harbors – Roe, Morrison, UNIDROIT Principles

The concerns raised about collateral damage, and the possibility that safe harbors might actually accelerate a financial crisis raise a serious question whether the safe harbors ought to be narrowed in scope. In the wake of the Madoff bankruptcy many have criticized the broad, flexible definition of the safe harbors that, coupled with strong protection for finality contained in US Law (and recommended in the Legislative Guide), turn the safe harbors into a discretionary contractual opt out from a bankruptcy case. Roe, Morrison and Sontchi have further noted that since 1982, and particularly in 2005, the scope of the safe harbors has expanded to cover a greater number of instruments.1 Steve Schwarcz has called this expansion of the safe harbors “path dependent,” but his implication is that the expansion has followed the desires of particular interests for exemption from bankruptcy, rather than the original purpose of ensuring the integrity of systemically important financial products.2 With this concern in mind, Roe, Morrison and Sontchi have advocated limiting the safe harbor for repurchase agreements to those repurchase agreements that are collateralized with treasury or other money-like securities.3 Similarly, the broad definition of terms like “settlement payment” and “financial contracts” have led commentators to argue for limiting the scope of the safe harbors to securities that are in the process of clearing through intermediaries, or where the transactions themselves have systemic risk implications. In sum, instead of a broad and flexible approach, the safe harbors might be limited to transactions, parties and instruments where clearly identified policy concerns mandate exemption from the bankruptcy stay.

It should be noted that the current broad scope of the safe harbors (also reflected in the ICR Standard) may be in tension with both the FSB Key attributes and the UNIDROIT Principles. The FSB Key Attributes focus on the nature of the instruments. Key Attribute 5.1 argues that there must be a transparent explanation why systemic risk concerns mandate special treatment for a particular type of financial contract:

Resolution powers should be exercised in a way that respects the hierarchy of claims while providing flexibility to depart from the general

---

3 Securities that are held by money market funds create problems if they trade at less than par. In their view the safe harbors should only be extended to securities where this risk is present.
principle of equal (pari passu) treatment of creditors of the same class, with transparency about the reasons for such departures, if necessary to contain the potential systemic impact of a firm’s failure or to maximise the value for the benefit of all creditors as a whole.

By contrast, the current broad and flexible standard, might not be transparent and appears to cover transactions where the link to systemic reasons for departure from equality of treatment is attenuated at best.

The UNIDROIT Principles, by contrast, preserve immediate close-out netting, but narrow the class of parties protected. The UNIDROIT Principles recognize that in bankruptcy the concern is clearance risk and financial institution safety and soundness, so the only entities entitled to immunity are so-called “Qualified Market Participants.” This would limit the availability of immediate close-out netting to financial institutions, financial intermediaries and public authorities. While UNIDROIT Principle 4(2) contemplates that the immunities might be broadened, an independent policy reason for doing so would have to be specified. As such, careful attention to the precise transactions granted immunity, and limiting the parties eligible to claim immunity to “Qualified Market Participants,” would bring the ICR Standard closer to consistency with the UNIDROIT Principles and FSB Key Attributes.

II. Discretionary 10 Day Stay – Roe and Adams

Another possibility is suggested by Mark Roe and Stephen Adams. They suggest that the best way to both preserve netting rights and limit clearance risk while avoiding value destruction would be to allow netting, but only after a stay of 10 days. The purpose of the stay would be to allow the financial contracts to be transferred to a solvent party, or to allow the debtor to arrange a sale of the business. This would also give the court an opportunity to ensure that the allegedly safe harbored transactions were, in fact, properly characterized as such. The stay would automatically be lifted after ten days unless the court decided to extend it for a second ten days in order to facilitate an orderly wind down of the debtor’s assets. Such an approach would allow for preservation of value, by permitting an orderly transfer of a financial firm’s portfolio of financial assets. The stay would be finite, so while netting would not be immediate, it would not be indefinitely delayed. Whether 10 days is too long would need to be considered.

III. Symmetric Approach – FSB, Skeel and Jackson

Some argue that it might be desirable to seek symmetric treatment of financial contracts across resolution/restructuring regimes by symmetrically applying the FSB Key

---

4 Mark Roe and Stephen Adams, Restructuring Financial Firms in Bankruptcy: Lessons from Lehman (on file with authors).
Attributes approach under both the bankruptcy and bank resolution regimes. David Skeel and Thomas Jackson, among others, have advocated such an approach.\textsuperscript{5} Such a symmetric approach might be built around four basic principles:

1. Respect of setoff rights;

2. A bankruptcy moratorium on setoff and termination rights applicable to all debtors regardless of insolvency regime (ordinary insolvency and financial institution resolution); and

3. If the particular insolvency regime’s moratorium continues beyond a short period, an automatic (non-discretionary) lifting of that moratorium after 1–3 days for a discrete, well-defined, list of financial instruments that have been determined to have systemic risk implications.\textsuperscript{6}

4. Continued suspension of setoff and termination rights if the financial contract is transferred to a creditworthy third-party or bridge institution.

This symmetric approach would address systemic risk similarly across systems. Concern about counterparty or TBTF risk would be addressed through a short stay (to allow enough time to arrange a bridge-bank transaction) while clearance risk would be minimized by preserving close-out netting, albeit after a short delay. This symmetric approach may, arguably, have a number of advantages over the current sectoral regime that is divide between banks, SSFIs and ordinary debtors.

First, the respect of setoff rights would ensure that a financial institution’s exposure could be managed as a net obligation rather than in gross. For example, under U.S. Bankruptcy law, Section 553 of the Bankruptcy Code preserves state law setoff rights. Section 506 treats those setoff rights as if they were a security interest and gives the creditor an allowed secured claim. As a secured creditor, the creditor is entitled to adequate protection. Netting happens, just not immediately.

Second, delaying setoff allows for preservation of value. For ordinary, non-financial firms, the delay may be somewhat longer, and the money subject to setoff may be treated as cash collateral and used to operate the business. In ordinary bankruptcy cases, the power to use cash collateral is essential to preserving the firm’s going concern


\textsuperscript{6} The definition may be limited in terms of types of financial contracts and/or the parties to financial contracts (see e.g. the definition provided in the UNIDROIT principles as a minimum standard).
value. Even for financial firms holding financial contracts, some delay is necessary, because a bridge transaction must be arranged. This can usually be done very quickly, however, because the assets are liquid. The delay in those cases need only be a few days.

Third, for a defined set of financial contracts, perhaps with a defined set of parties, the moratorium can be lifted automatically after a short period that matches the period available under the bank resolution regime. If such treatment were generalized, and applied in general insolvency as well as in a resolution context, then financial firms (whether banks or non-banks) would be able to accomplish bridge-bank transactions even if they found themselves in insolvency rather than a resolution proceeding.

IV. Abolish the Safe Harbors in Bankruptcy – Roe, Lubben et al.

Since the failure of AIG and Lehman, there has also been considerable commentary among bankruptcy academics and those specializing in bank regulation about the possibility that the bankruptcy safe harbors may actually increase contagion within the banking system rather than isolating it. Mark Roe, 7 Stephen Lubben, 8 have discussed this problem at length, particularly where the failed institution is systemically significant. They have questioned whether the safe harbors are necessary at all. After Dodd-Frank, only systemically insignificant institutions would be involved. Clearinghouses can ensure that a single firm’s failure will not disrupt the clearance process. In practice, however, there are some derivatives where significant clearance delay could have other policy relevant implications. Many derivatives serve important hedging and planning functions in the economy, and there may be some need to preserve these functions. For some other financial instruments concerns relating to monetary policy (in addition to banking and bankruptcy policy) come into play, and it might be dangerous to subject such instruments to a potentially lengthy stay in bankruptcy. However many derivatives are simply speculative devices which serve little, if any, underlying economic function. These commentators believe that the current regime does not sort effectively among these different types of derivatives. In their view, the safe harbors should be abolished, or significantly narrowed so that they only cover instruments where there is a manifest need to do so.