The World Bank
Insolvency and Creditor/Debtor Regimes
Task Force Meetings

Bankruptcy Treatment of Financial Contracts: Lessons for Developing and Emerging Markets

January 11, 2011
Held at the World Bank
Washington, DC

Rapporteur's Synopsis

By the Honorable James M. Peck, New York, NY

Issues addressed by the panel and background material

The issues addressed by the panel were the following:

(i) the best arguments for conferring immunity from certain bankruptcy rules on counterparties to financial contracts; whether these arguments have been tested in crisis, and if so, to what effect;

(ii) the net effect of bankruptcy immunity for financial contract creditors on the control or spread of financial crises;

(iii) whether such bankruptcy immunity distorts creditors' *ex ante* monitoring and exposure reduction incentives;

(iv) whether such immunity leads to greater reliance by debtors on particularly risky capital structures, thus increasing likelihood of default;

(v) the effect of such bankruptcy immunity on the equitability of the distribution of insolvency loss;

(vi) in the context particularly of developing and emerging markets, would policymakers and legislators be well-advised to enshrine bankruptcy immunities in their nations' bankruptcy codes; whether legislative responses more finely tuned than bankruptcy immunities are available to preserve the net social benefit of financial contracts while reducing their deleterious effects on creditor and debtor incentives;

(vii) the effect of holding financial contracts on distress resolution bargaining incentives (the 'empty creditor' hypothesis); and

(viii) what adjustments might be made in formal and informal distress resolution frameworks in order to respond to 'empty creditor' incentives?

The background materials to the session were the following:

(i) *The Importance of Close-Out Netting* (ISDA, 2010);[1]

(ii) *The Derivative Markets' Payment Priorities as Financial Crisis Accelerator* (Roe, 2010);[2]

(iii) *The Bankruptcy Code without Safe* Harbors (Lubben, 2010);[3]

(iv) *Exemption of Financial Assets from Bankruptcy* (Westbrook, 2008);[4]

[1] Available online at http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf
[2] Available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1567075
[3] Available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1569627

(v) *Debt, Equity, and Hybrid Decoupling: Governance and Systemic Risk Implications* (Hu and Black, 2008);[5]

(vi) *Credit Derivatives, Market Design, Creating Fairness and Sustainability* (Sarra, 2009);[6] and

(vii) *The Empty Creditor Hypothesis* (ISDA, 2009).[7]

Composition of the panel

The panel consisted of:

(i) Edward Janger, Brooklyn Law School;

(ii) Adam Levitin, Georgetown Law School;

(iii) Stephen Lubben, Seton Hall Law School;

(iv) Riz Mokal (moderator), The World Bank;

(v) Edward Murray, International Swaps and Derivatives Association;

(vi) Mark Roe, Harvard Law School; and

(vii) Michael Simkovic, Seton Hall Law School.

Issues presented by the panelists

Background and overview of session

The multi-trillion dollar global market in derivatives provides an important source of liquidity and is a principal means by which financial institutions manage and mitigate financial risks. Transactions in this market range from the relatively routine (interest rate and currency swaps) to the more exotic (e.g. swaps linked to synthetic collateralized debt structures). Because underlying valuations of referenced assets and indices necessarily are variable, market participants expect that the offsetting obligations of counterparties will be marked to market expeditiously in order to fulfill the essential business purposes

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[4] Available online at http://judiciary.house.gov/hearings/pdf/Westbrook080926.pdf
[5] Available online at http://www.efmaefm.org/eufm_450_corrected.pdf
[6] Available online at http://www.sustainablefinancialmarkets.net/wp-content/uploads/2009/02/sarra-credit-derivatives_20jan091.pdf
[7] Available online at http://www.isda.org/researchnotes/pdf/ISDA-Research-Notes3.pdf

of the applicable financial contract. The prompt fixing of these obligations helps to avoid potential mismatches caused by market movements that would distort financial outcomes.

The session dealt with the treatment of these financial contracts in both theoretical and practical terms. The panelists approached the topic from different perspectives with certain members noting the importance of a system that broadly allows parties to offset or net their mutual obligations arising under derivative transactions without hindrance or delay and others expressing some skepticism and concern especially as to (i) the effect of unfettered netting rights on the orderly disposition of a debtor's assets, (ii) the possible role of financial contracts in increasing the adverse impact of the financial crisis and (iii) the definitions of "financial contracts" that are so broad in their potential application that they may "swallow" certain core principles of bankruptcy relating to debtor protections, collection of assets and equal distribution among creditors within designated classes.

Despite concern as to the scope and proper application of the safe harbor provisions, the panelists generally were in agreement that there are sound reasons for exempting certain categories of financial contracts from insolvency risks (notably, the automatic stay, the invalidation of *ipso facto* provisions, preference risk and fraudulent conveyance exposure) in that they provide material benefits to market participants and to the worldwide economy in the form of greater predictability and stability in the global derivatives market. One panelist asserted, and the others did not dissent from, the proposition that counterparties to repurchase or swap agreements had the reasonable expectations of being able to close out and net their respective positions without having to wait for an indefinite period of time (especially given the rapid valuation changes in marking to market the underlying financial assets or indices) and that these contracts, in order to perform predictably and appropriately in accordance with the intentions of the parties, must be effectively insulated from all meaningful bankruptcy risks.

Thus, the panel agreed that repurchase agreements ("repos"), swap agreements and derivatives occupy a special place within sophisticated financial markets and provide useful tools for managing risk and promoting liquidity. The panel members, however, did note some obvious unresolved tension between the legitimate needs and expectations of market participants and the goals of preserving and maximizing the value of the estate for the benefit of other stakeholders. According to the discussion that ensued, it seems likely that this natural tension will be resolved in varying ways depending upon the particular policy objectives of each insolvency regime, but it is foreseeable that the very existence of exemptions will provide incentives to structure transactions that fit within the safe harbors.

Rationale for "safe harbors"

Those who support safe harbors asserted that they are needed exceptions in those bankruptcy regimes with applicable law that otherwise would limit contractual rights of set off or which do not possess expansive statutory insolvency set-off rules. They believe that exemptions from both the limitations imposed by any bankruptcy stay and avoidance exposure provide a mechanism to strengthen legal certainty between counterparties, thereby reducing credit risk and systemic risk by enabling parties to promptly close out and determine the net amount of their respective exposures without regard to the insolvency of one of the counterparties. Because timing is critical in determining amounts payable by one party to another upon early termination of a financial contract, the safe harbor provisions allow these obligations to be determined with certainty and without undue delay. Supporters of safe harbors also submit that the provisions minimize the risk of a chain reaction of negative financial consequences to other counterparties – the risk of so-called contagion. Additionally, safe harbors authorize master netting arrangements that allow for the aggregation of multiple offsetting contractual obligations between the same parties and avoids the potential distortion that may be caused by the decision to assume only selected contracts that are “in the money” to the debtor. Such master netting arrangements produce a net amount due from one party to the other that reflects the commercial expectations of the parties with respect to a portfolio of related financial contracts.

Assessing the arguments in favor of immunities

While some commentators have contended that the net amount to be paid or received at the time of close out and netting is not a factor to be considered in determining the going concern value of an enterprise, one member of the panel argued that the benefits of a derivative can be essential to such an analysis as in the example of an “in the money” hedge of jet fuel for an airline debtor who files for bankruptcy and who, going forward, would have to reorganize with no hedge on the price of fuel. This part of the panel discussion highlighted the distinction between financial contracts in which the counterparties are financial institutions and those in which a business enterprise is able to realize a measurable financial benefit of a derivative in its ongoing operations. As a policy matter, those who argue in favor of immunities for a repurchase agreement are essentially advocating preferential insolvency treatment for a transaction that functions for commercial purposes as a secured financing. In effect, the safe harbor for repos gives this special brand of financing a significant bankruptcy advantage over conventional secured financing and amounts to an incentive to structure financings as repos. Critics of the safe harbors also contend that these provisions of the United States Bankruptcy Code, as amended in 2005, have been worded so broadly that more conventional commercial transactions can be characterized as financial contracts thereby giving parties to such contracts the ability to seek preferential treatment despite the fact that they are not systemically significant parties for whom prompt and predictable close out netting should be an important consideration. Such critics also argue that a general application of the safe harbors to creditors that are not true financial counterparties is unfair and gives such parties an opportunity to side step the bankruptcy process, obtain advantages not available to other creditors of like class and conduct a set off without notice to other stakeholders. Certain members of the panel took the position that the safe harbors have been expanded beyond their original purpose and may now be susceptible to overly expansive interpretations that may produce unintended consequences that may be contrary to certain basic bankruptcy objectives. The panel, as a whole, appeared favorably disposed towards amendments to the safe harbors that would limit the potential for abusing these provisions.

Contagion and incentives

Systemic risk has two main dimensions: the risk of collateral contagion (values being driven down by turbulent market forces) and information contagion (the need to understand a previously ignored or unknown credit risk). In transactions that are subject to the safe harbor provisions, counterparties are protected from some of the consequences of collateral contagion by being able to sell collateral right away without having to first obtain permission from the bankruptcy court. Parties are also able to engage in transactions in the first instance without having to conduct extensive diligence as to the financial strength of each counterparty and can rely on the ability to close out a transaction even if a counterparty were to commence a bankruptcy case that triggers the right to early termination of the contract. This right to terminate the contract and sell the collateral allows parties to dispose of assets in a distressed market, and this may be a factor that contributes to the severity of a financial crisis. Because risk does not simply disappear, it is assumed that, in practical terms, the collateral contagion and credit risks are transferred to the government as the source of ultimate recourse for 'too big to fail', systemically significant counterparties. In the absence of safe harbors, counterparties presumably would have greater incentives to expend resources to monitor the credit strength of each trading partner and would demand incremental compensation within the financial contract for taking on greater insolvency risk. The panel did not address the net effect of these bankruptcy immunities on the overall risk of contagion, but did consider certain capital structure consequences as noted below.

Effects on Capital Structure

Safe harbors may also increase systemic risk by encouraging businesses to engage in transactions that are not disclosed to third parties and that tend to disguise or obfuscate all of the material obligations of a financial enterprise. Traditionally, a corporate borrower would enter into secured financings that would grant priorities (i.e. security interests) that are reflected on the public record. Third parties would be able to perform a lien search and make independent assessments as to the degree of risk posed by priority claims of senior creditors before deciding to extend credit. Disclosure of a lien is a prerequisite to being granted an enforceable priority claim against designated collateral. In this classic lending environment, the amount of leverage applicable to a particular debtor entity could be readily identified and evaluated. By virtue of the safe harbors, however, debtors now have incentives to obtain financing by means of repos that afford liquidity without the filing of security interests and with correspondingly less transparency. It has been suggested that this may lead to the inequitable result of third parties being granted immunity from bankruptcy and what amounts to a priority distribution without having complied with any of the traditional requirements of secured financing. One consequence of the safe harbors is a preference for repo financing resulting in less publicly available information about those creditors that are entitled to preferential treatment of their claims against the borrower.

Effect of holding such instruments on distress resolution bargaining incentives

Creditors that hold credit default swaps, total return swaps, short options or insurance, or that have investments across the capital structure or in other related entities may be deemed so-called “empty creditors” as a result of the separation of their economic interests from the right to vote their claims or to take action as a disinterested creditor in a bankruptcy case. This divergence between the economic incentives normally associated with holding a particular claim or class of claims in a bankruptcy case and the reality of that creditor’s other and potentially predominant economic interests is distorting and may lead to false signaling and seemingly curious or implausible behavior both before and during a bankruptcy case. A creditor that also happens to be the holder of a credit default swap payable upon commencement of a bankruptcy of the referenced entity may have every incentive to obstruct an out-of-court restructuring rather than support a proposal that on its face would appear to be beneficial to similarly situated holders of claims. The best outcome for such a creditor is flipped because insolvency becomes the preferred outcome that will result in an enhanced recovery. Disclosure of the split between appearance and reality is not currently required for individual creditors but can be compelled by the court under certain circumstances, particularly when a creditor takes action that is conspicuously at odds with what a rational creditor would be expected to do under the same circumstances. Bankruptcy Rule 2019 has been revised to attempt to address this problem in the United States by requiring creditors who are acting together in a case to disclose the existence of such divergent economic interests. This rule is scheduled to become effective in December 2011. With the exception of this rule, there are few workable remedies for abuses of the bankruptcy process by an empty creditor, and the panelists noted that their proposals to sanction creditor misbehavior caused by the undisclosed holding of derivatives could be criticized as a remedy that either attempted to do too much or too little. These proposals include limiting the “empty” creditor’s voting rights or entitlement to distributions (by means of subordination or disallowance). In the absence of clearly inequitable conduct by a party seeking to influence the outcome of a bankruptcy case, some panel members believe that it is doubtful that any of these remedies can be employed successfully.

Possible developing/emerging market legislative responses and general discussion

According to one member of the panel, any jurisdiction that, on the basis of domestic policy considerations, made the choice to adopt an insolvency regime with provisions that interfered with or materially delayed close out netting would be making a mistake because such provisions would place that jurisdiction at a distinct competitive disadvantage in the global market for derivatives. No one else from the panel took issue with that assertion, but, given the lack of any discussion on the point, it is not known whether silence from the other panelists should be interpreted as agreement or whether the other panel members would concur with the proposition that liberally permitting offsets in derivative transactions is a necessary feature of any insolvency regime structured with the objective of not discouraging financial innovation. Nonetheless, particularly in situations where the infrastructure of the court system may not be well developed or the judges may not have experience dealing with sophisticated business transactions, it seems likely that market participants can be expected to insist that certain types of transactions should be exempt from bankruptcy risk.

A comment was made during the general discussion that the safe harbors are but one example of attempts by financial institutions to develop structures or enact immunities that increase the likelihood that certain classes of transactions will yield economically predictable results. The strategies employed may differ, but the objectives appear to be the same – to minimize the risk that particular transactions will find their way into a bankruptcy court and thereby become exposed to unpredictable and hard to manage elements of risk associated with the exercise of discretion by a court (such as delay or the risk of adverse litigation outcomes).

There was insufficient time to directly address and develop answers to the central question of whether safe harbor provisions should be adopted in developing and emerging markets.

Overall conclusions

In their various presentations, a number of the panelists seemed to be critical of the provisions as currently enacted in the United States, and it seems unlikely that they would recommend adoption elsewhere of comparable provisions with the potential for such expansive applications. However, the comment of one of the panelists who had criticized the broad scope of the safe harbors may be significant. He noted that many jurisdictions had regimes that were based on liquidation of a debtor's assets rather than reorganization. In such jurisdictions, narrowly tailored safe harbors might be considered.

Despite the skepticism of some members of the panel regarding the breadth of safe harbors and the distortions caused by these provisions, the panelists were realistic and recognized that financial institutions will continue to insist on having the right to predictably close out and net mutual exposures in derivative transactions and can be expected to argue in favor of legislation that will promote global uniformity in the treatment of financial contracts.

Next steps

There needs to be a continuation of the Task Force's work and analysis. As part of that effort, the World Bank will produce an issues note on the topics covered in the session.

The Honorable James M. Peck, New York, NY
Rapporteur

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