Executive summary

Insolvency arrangements and contract enforceability

Recent episodes of financial stress (Enron, LTCM, LTCB) demonstrate the importance of having effective means to achieve the rapid, efficient and equitable resolution of troubled and insolvent companies with extensive financial operations. The challenge is made greater by the increasing global reach of ever larger and more complex financial institutions and non-financial firms with substantial financial activities. The rapid evolution of the environment in which insolvencies occur and the more measured evolution of insolvency regimes have created notable tensions and significant pressures for change. Effective resolution techniques are needed for financial institutions and other active financial market participants in order to contain systemic risk, limit moral hazard and reduce the distortions that arise from the existence of the safety net.

This report examines the objectives and operation of insolvency processes (particularly for financial institutions and non-financial firms with substantial financial activities) in countries with well developed economic, financial and legal infrastructures. It was prepared by the Underpinnings Contact Group. It is based on two comprehensive surveys: of insolvency arrangements for financial institutions and financially active non-financial firms and of the treatment of financial contracts under these insolvency arrangements. The contracts include closeout netting and offset provisions, finality rules in payment systems and collateral agreements to support financial transactions.

The report is exploratory in nature. It considers broad trends in financial markets and insolvency procedures and seeks to suggest perspectives and problems worthy of further investigation. Hence, it does not make concrete policy recommendations, but recognises the need for further analysis and research by academics, practitioners and the public sector.

Framework of analysis

How should we evaluate and compare alternative insolvency processes and private workouts? The criteria used in this paper derive from the goals for the design of insolvency arrangements. These goals are (1) reduction of legal and financial uncertainty, (2) promotion of efficiency and (3) provision of fair and equitable treatment. Increased legal certainty helps market participants form a probability distribution around the outcomes of financial transactions, and to make choices based on their willingness to bear risk. The promotion of efficiency involves the alignment of the incentives of managers, creditors, shareholders and other actors in the bankruptcy process. It also involves devising effective means to reduce the risk of moral hazard. Equitable treatment reflects consensus about the relative burdens between debtors and creditors and among creditors in insolvency, expressed in the rules and payment priorities in the insolvency process.

These three objectives are often complementary. For example, a degree of legal certainty is necessary in order to measure efficiency or equity. Similarly, laying out a preordained hierarchy of claims that debtors and creditors know will be observed when liquidating a firm not only establishes relative equity but also increases legal certainty and efficiency in that each class of creditor can expect to be treated consistently and in accordance with expectations when a liquidation occurs. Legal certainty and efficiency, and to some extent equity, contribute to lowering liquidity and systemic risks in that they reduce the potential for market disruption and large deadweight losses.

Yet tensions can and do arise among these three objectives. For example, legal certainty about closeout netting may make parts of the insolvency process quicker and more efficient. But it may also change the effective priority of claimants and thus the equity among creditors in an insolvency.

One outcome, which is almost always consistent with reconciling tensions among the three objectives, is to maximise the value of the bankruptcy estate. Fully realising the value of the firm’s assets is consistent with efficiency. Because creditors are repaid according to an established set of priorities, a larger bankruptcy estate also means that no creditor is worse off and some are better off. Resolution approaches that are both speedy and have low transactions and administration costs are generally most effective in preserving the value of the bankruptcy estate and limit spillover effects on third parties through payment and settlement systems or through key financial markets. Thus, in the absence of market failure, maximising the value of a troubled institution should be consistent with minimising the loss to society associated with the episode of stress at that financial institution.

Principal findings

Based on an analysis along these lines, the principal conclusions of the report are:

1. Speedier, market-based insolvency mechanisms appear to better meet the needs of participants in advanced financial markets. These mechanisms, such as the use of auctions and expedited asset sales, are based on the increased capacity to price and sell in markets many components of the company that were previously “firm-specific”, that is, specialised to the insolvent firm’s activities and sold with difficulty to others. The availability of markets allows creditors to estimate more precisely asset prices and ultimate recoveries. Market-based mechanisms increase efficiency and the bankruptcy estate available to be paid out. This suggests that reforms in insolvency regimes that make them quicker and more market-based could be largely equity-neutral, in that no creditor or stakeholder would be worse off than under current arrangements.

2. Speed in the insolvency process is especially important for credit exposures to insolvent firms in those market segments where risk and liquidity are transferred among large financial market participants. In those markets, disruption could have spillover effects on other market

participants and spread disturbance across the financial system. The reliance by financial institutions and other financially active firms on traditional and innovative financial instruments to manage liquidity and risk is reflected in the huge daily volumes of transactions in key financial markets and in payment and settlement systems. This reliance has augmented the need for legal certainty. In response, legislation at the national level has provided precise finality rules, closeout netting and offset provisions, collateral arrangement and other contractual and statutory provisions that “carve out” some transactions from formal insolvency processes. Carve-outs effectively change the priority of creditors and potentially can make some creditors (eg unsecured creditors) worse off. The widespread adoption of such statutes suggests that, at the national level, the gains in legal certainty and efficiency are seen as large relative to the reduction in equity to any creditors. These gains in certainty and efficiency are largely seen in simplified transaction planning and reduced systemic risk, because these carve-out statutes do not substantially simplify the liquidation process itself, which must still resolve the non-financial assets and liabilities.

3. Additional financial arrangements, notably securitisation and outsourcing, appear to facilitate more efficiency and legal certainty in the insolvency process. Such techniques have the additional feature of reducing the assets and liabilities of the insolvent firm in insolvency. (Outsourcing reduces the true size of the firm; securitisation reduces the firm for insolvency purposes, by recharacterising secured loans as sales.) While such market-driven arrangements may be efficient, they may also have implications for equity by de facto revising creditor priorities in insolvency. The use of these arrangements is occurring with much less explicit legislative consideration of their impact on the insolvency process and how the positions of debtors and creditors are being affected.

4. Differences in national insolvency laws, reflecting national consensus about equity concerns and appropriate insolvency procedures, might create tensions at the international level.

- Creditors and debtors may be able to initiate insolvency proceedings in one of several relevant jurisdictions. In particular, differences exist across jurisdictions in the statutes concerning the enforceability of financial contracts which may complicate their execution in insolvency. Moreover, some jurisdictions permit the liquidation of financial institutions under a single entity approach (where assets are pooled and distributed to all creditors according to priorities set for the whole entity), whilst others adopt a separate entity approach (where certain assets booked to local branches are subject to local jurisdictions, thus taking advantage of or at least highlighting these differences.

- These differences have three effects in common. They increase legal uncertainty, because the jurisdiction and prevailing law and approach can vary as the location and nature of the insolvent firm’s assets and activities and as the firm’s counterparties vary. Efficiency can be reduced, especially where multiple jurisdictions and conflicting laws make predicting outcomes more difficult and create complex coordination problems. Equity may be impaired, since the debtor or creditor may not receive the treatment and priority that was expected in entering into a financial transaction. Furthermore, the outcome of jurisdictional differences on the single/separate entity approach may not seem equitable to all creditors.

Despite the variety of potential tensions, occasional cross-border insolvencies in recent years have not created substantial disruption. Comity among jurisdictions in the limited number of large failures in recent years has proved helpful in keeping the tensions under control.

Recent developments

Market participants and the official sector are actively working to address specific problems for cross-border insolvencies in those areas in which tensions are most apparent, and substantial progress is being made. Some examples are:

- The European Union has created an approach for coordinating cross-border liquidation of financial institutions: the EU Winding-Up Directive. The innovation in this Directive is that it specifies a unique main insolvency forum, at least for parties within the European Union.
- Recent private international law reform efforts have succeeded (or are progressing) in providing a definite location to cross-border intangible collateral. These efforts include the UNCITRAL Convention on Cross-Border Receivables and the Hague Conference on Private International Law, concerned with interests in securities held through financial intermediaries.
- Within the European Union, a proposed Directive on financial collateral arrangements has just been promulgated. This Directive will provide a special regime for the creation, perfection and enforcement of certain collateral arrangements.

The intention of the above initiatives is not to harmonise the relevant substantive laws but to identify best methods of coordination and extend them Community-wide or worldwide through instruments such as a Directive or Convention.

In a few limited contexts, substantive rules of law have been harmonised, particularly regarding collateral. Examples include the UNIDROIT Mobile Equipment Convention and Aircraft Protocol, and select parts of the UNCITRAL Receivables Convention. UNIDROIT also is beginning a project harmonising the substantive law of securities collateral.

Taken together, these efforts demonstrate that the problems of cross-border insolvency have been recognised broadly in G10 countries and that the industry and the official sector have been able to make significant progress in reducing legal uncertainty, increasing efficiency and improving the ability of market participants to develop probabilities of how claims will be treated under insolvency. Nonetheless, cross-border insolvencies of financial firms and non-financial firms with substantial financial activities will probably continue to rely substantially on comity among jurisdictions and a high degree of cooperation among supervisors, and the insolvency process is likely to remain costly. Clearly, therefore, much further work along the lines of that already under way could be done over time with the encouragement and active participation of financial authorities.