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Draft Principles regarding the enforceability of close-out netting provisions

COMMENTS

RECEIVED BY UNIDROIT IN ENGLISH

(submitted by Governments and Organisations)

INTRODUCTION

The UNIDROIT Secretariat has invited the Governments of its Member States as well as Regional Economic Integration Organisations, Intergovernmental Organisations and International Non-Governmental Organisations to formulate comments on the text of the UNIDROIT Draft Principles regarding the enforceability of close-out netting provisions (C.G.E./Netting/1/W.P. 2 and Addendum) for consideration by the Committee of Governmental Experts on the enforceability of close-out netting provisions at its first session from 1 to 5 October 2012.

As of the morning of 14 September 2012 the UNIDROIT Secretariat has received comments in English language on the Draft Principles from:

- the Governments of Poland, Sweden and the United States of America; and
- the United Nations Commission on International Trade Law.

These comments are reproduced hereunder.

COMMENTS SUBMITTED BY MEMBER STATES

Poland

Firstly, the idea put forth by UNIDROIT regarding the creation of regulations, which would ensure applicability of netting clauses to trades on the financial market on an international level, is very commendable. Experience gathered from the 2008 global crisis shows that financial institutions require legislative solutions for limiting contractual risks. Furthermore, considering the

scale and importance of trade in the financial sector, limitation of such risk would also affect the stability of various financial markets.

This undertaking is further supported by the existence of international financial interrelations between particular financial markets.

Unification of the netting issue in a global scope is an extraordinarily difficult task, due to the multiplicity of existing legal solutions and considerable systemic differences in each country. Effectiveness of cross-border solutions in the area of close-out netting depends therefore on the degree of discrepancy between the proposals put forward by UNIDROIT and the solutions, which are being currently used in Poland.

It should be noted that the proposals of UNIDROIT significantly extend the scope for use of netting in bankruptcy in comparison to Polish laws, as the Polish legislator introducing bankruptcy netting to the *Act of 28.03.2003 – The Bankruptcy and Reorganization Law* (OJ [Dz. U.] of 2009, Issue 175, item 1361 as amended, referred to henceforth as "Bankruptcy Law" — had limited its use to bankruptcy of parties to framework agreements. Therefore, the scope of proposal presented by UNIDROIT, which would allow close-out netting in many various situations, including solvency, seems to be too far reaching.

The Polish legal system does contain regulations that partially implement the idea of insolvency netting proposed by UNIDROIT, such as Article 85 of the Bankruptcy Law. Per the text of this law, if a framework agreement, to which one of the parties is bankrupt, states that if specific detailed agreements for forward financial operations, loans of financial instruments or sales of financial instruments with mandatory redemption clauses shall be concluded within said framework agreement, and the termination of such framework agreement shall result in the subsequent termination of all detailed agreements encompassed by that framework agreement, then:

1) any receivables from any detailed agreement encompassed in the framework agreement shall not be included in the insolvency proceedings;

2) the insolvency official shall not be entitled to terminate the framework agreement described in Article 98 of the Bankruptcy Law.

In this Law, forward financial operations are defined as operations, where prices, exchange rates, interest rates or index have been agreed upon, in particular purchases of currency, securities, gold or other precious metals, goods or rights, including agreements calculated only for price differences, options and derivative rights, concluded for a specific date or period, and used in market trade. In the subsequent text of this Law, financial instruments are defined within the meaning of regulations of *Act of 29.7.2005 on The trade in financial instruments* (OJ [Dz.U.] of 2010, issue 211, item 1348 as amended). Furthermore, each party may terminate the framework agreement, while maintaining the settlement process for the parties, which has been provided for in said agreement in the event of termination. In addition, deduction of receivables resultant from these settlements between parties is allowed. It should be noted that detailed agreements concerning forward financial operations, loans of financial instruments or sales of financial instruments with a mandatory redemption clause are not subject to provisions of Articles 98 and 99 of the Bankruptcy Law, even if these had not been concluded within the framework agreement.

Moreover, we share concerns of UNIDROIT regarding the issue of a walk-away clause (items 30 and 31 of the draft), which is currently used in contractual practice, and which may result in situations, where if the balance is positive for the solvent party, the netting claim may only be granted to this party, whereas if the balance is positive for the insolvent party, the final claim is not

established. It should be indicated that in popular opinion, a two-way payments clause is fairer, as it provides for the establishment of a final claim for both parties, including the insolvent party.

It is possible that application of rules concerning compensation for liquidation may create situations, in which the performance of compensation agreements will result in rapid siphoning of assets from financial sector entities endangered with insolvency. In consequence, this might create a systemic risk and work against the interests of a wide group of individual and institutional investors.

Regardless of the above, it seems that a wide scope of proposed regulations should be considered, as it covers both the entities of the financial market, as well as other entities that are not related to this market.

In addition, the draft of these regulations allows for a future extension of the list of applicable entities. However, there is no provision, which would provide for the limitation of such list. Similar doubts can be raised in regards to the material scope of these regulations.

Sweden

Introduction

Sweden gratefully acknowledges the work of the Study Group and welcomes its draft principles. Sweden is also grateful for being given the opportunity to respond to the draft principles and is looking forward to fruitful discussions at the expert meeting in October 2012.

This paper contains Sweden's preliminary comments on the draft principles and other related issues. Sweden reserves the right to alter or modify its position as presented in this paper. Principle 9 will be commented upon at a later stage, possibly at the meeting in October.

General comments on the draft principles

Terms and concepts

Sweden appreciates that the draft principles contain definitions of several key concepts such as 'close-out netting provisions', 'eligible parties' and 'eligible obligations'. It is important to have consensus on the cornerstones of the draft principles. However, the concepts mentioned all comprise several other terms or concepts or relate to such notions.

For instance, the draft principles do not contain any explanation of what is meant by *netting* or *contract* as in 'close out netting' or 'contracts for the sale, purchase or delivery of…' or how *contract* relates to *agreement* (see principle 3). Further, the concept of 'eligible party' is dependent on several other terms and concepts (for instance, person, natural person, partnership, unincorporated association etc.) which are likely to have different meanings in different jurisdictions.[1]

The *International Swaps and Derivatives Association* (ISDA) has, as known, published a *Model Netting Act* in 2006 (MNA). The MNA also contains similar definitions but it is more elaborated , which has the benefit of making the MNA more comprehensive. For instance, MNA has definitions of netting and netting agreements, qualified financial contracts, persons, party etc.

It is worth considering if the draft principles should provide for more precise definitions of for instance, netting, contracts and agreements and persons etc. (see also specific comments on relevant principles below). One way forward would be to provide for a catalogue or list of

[1] As far as Sweden knows many jurisdiction have trusts or business organisations which not are classified as legal persons but as legal entities (for further comments on this matter see principle 3).

definitions of several terms and concepts which are all part of the cornerstone concepts of 'close out netting provisions', 'eligible parties' and 'eligible obligations', which could either be placed in the beginning or the end of document.

Specific comments on individual principles

Principle 1: Definition of 'close-out netting provision'

Proposal for an amendment concerning predefined event

According to the Principle, the definition of close-out netting requires a predefined event in relation to one of the parties. It is however not clear to us why the definition requires that the predefined is related only to *one* of the parties. It is quite possible that a predefined event could occur in relation to both parties; and in such circumstances it is not clear to us why that situation should not be equally covered by the Principle. Therefore the text should be amended to the effect that the predefined event may occur in respect of *at least one* of the parties.

Issues concerning the validity of Walk-away clauses

Sweden has some doubt if it is wise to avoid a statement regarding so-called walk-away clauses. In Sweden's opinion, such a clause can in certain jurisdictions cause the benefits of close-out netting to disappear. If walk-away clauses are permitted, it opens up for a form of *cherry-picking* since it is possible for a non-defaulting eligible party to be a party to several netting arrangements or agreements. Walk-away clauses may also cause legal disputes in cross-border cases since not all jurisdictions permit such clauses.

Similar issues can occur if a non-defaulting party is able to wait for a period of time or for an indefinite period before exercising its rights to terminate (to close out).

In Sweden's opinion it would be fruitful to discuss the validity of walk-away clauses and the possibility to postpone the exercise of a right to close out in order to see if it is possible to reach a common position which can be stated in the principles.

Sweden is not in favor of walk-away clauses since such clauses make close-out netting unpredictable. Sweden can consider limiting the period of time a party is able to exercise its rights to close-out netting. For the moment Sweden has no opinion about how long a maximum time period should be. The length of the maximum time period must however meet the needs of both financial stability and the principle of freedom of contract. Furthermore, it must be carefully considered in what kind of situations (types of default) a time limitation may be appropriate.

Principle 2: Definition of 'eligible party'

Natural persons

It seems that natural persons, who are not in a partnership or unincorporated association (see principle 2 b), fall outside the definition of eligible parties if the law of the relevant state does not state otherwise (see principle 2 c). This means that natural persons acting as individuals, although they may be considered to be professionals, fall within the scope of the principles only if so is provided for in relevant national law (cf. Directive 2004/39/EC Annex II).

In Sweden natural persons, who are acting professionally as individuals, can be parties in central clearing systems and netting arrangements as, for instance, providers of collateral. Sweden cannot see why it is necessary to exclude such natural persons from the 'mandatory' categories of persons who are included in the definition of eligible party (that is 2 a and b). If such natural persons are to be an optional category of persons, the interpretation of eligible party will most certainly be different among the relevant national jurisdictions. This can be a problem in a cross-border context, since eligible party is a cornerstone concept. Sweden fears that it will, as a smaller financial market, have a disadvantage if Swedish law should provide for natural persons to be

eligible parties. On the other hand, if Sweden for that reason refrains from such legislation, Swedish business practise will be hampered.

Approach of harmonisation

Another issue linked with the issue mentioned above about natural persons relates to the design of principle. The rule is a minimum harmonisation rule, since it provides that eligible parties shall at least include two categories of persons or entities (principle 2 a and b), with the option for the national legislator to provide for additional categories of 'persons' (principle 2 c).

The approach has two drawbacks. Firstly, it is dependent on the definition of person, which is however not defined in the draft principles. Secondly, the principle permits the national legislator to add more 'persons' to the definition of eligible party. These two circumstances mean in fact that the whole principle will be in the hands of national law since there is no, as far as Sweden knows, international consensus on what a (legal) person is.

Since it is unlikely that a consensus can be reached on which kind 'persons' should fall within the scope of the principle, Sweden suggests that the principle is drafted in a way that does not impede natural and legal persons and other legal entities opportunities to safely conduct business on the financial markets. From Sweden's point of view, it makes no sense to limit the effectiveness of close-out netting by reference to types of market participants. The systemic risk reduction of effective close-out netting benefits all potential professional actors on the financial market. A limitation based on certain types or categories of can potentially lead to difficult issues of characterizations and will create legal uncertainty and require periodic updates to meet the evolution of a dynamic market[2].

As mentioned in the Addendum (see sections *Key considerations and Explanation and commentary*, p. 8) it is best if the principle is as broad as possible, given that it is well-nigh impossible properly to classify the different types of actors in the financial market. Sweden agrees with the conclusion that the key question is what kind of business should be included within the ambit of close-out netting (see page 8 in the draft principles). The material scope of the principles should therefore be limited primarily by principle 3, the definition of 'eligible obligation'.

Drafting proposal concerning 'eligible party'

> **"2. "Eligible party" means <u>any person or legal entity constituting one of the parties to a netting agreement</u>.**
>
> **<u>States may decide not to apply these principles on individuals (natural persons) or apply these principles only to restricted classes of individuals</u>."**

Principle 3: Definition of 'eligible obligations'

General

The benefit of netting legislation is closely linked to certain activities (business) on the financial market which generates counterparty (credit) risks. Since close-out netting involves a regime which derogates from the normally applicable insolvency rules, it is important that derogation is justified on valid grounds, such as financial stability and improving the efficiency of the payment systems. The rule maker must decide which kind of matters or activities should benefit from derogation and define the derogation in a principle or a rule. That decision involves a choice of policy.

Sweden is of the opinion that such a principle or rule should primarily concern professional (or wholesale) business on financial markets. The principles should therefore apply to a qualified

[2] ISDA, Memorandum on the Implementation of Netting Legislation, *A Guide for Legislators and Other Policy-Makers*, March 2006, p. 4.

group of 'contracts, agreements and transactions' concluded on financial markets. However, the principle must also facilitate a smooth application with a clear and foreseeable result. This speaks for a comprehensive list specifying "financial contracts". On the other hand, the criteria defining "financial contracts" must be capable of accommodating continuing development and innovation in financial markets. This speaks for a more functional approach with a definition of "financial contracts" in general terms.

Against this background Sweden prefers that principle 3 provides not only for a list of 'contracts' which are 'eligible obligations', but also provides for a general definition of what 'eligible obligation' means. If the principle comprises both these elements, it will be capable of being legally certain and flexible.

Paragraph (c) – Title transfer collateral arrangements

In section 58 it is stated that, in relation to paragraph (c) of the Principle, "No property interest is retained on the provider's side". Although there are good grounds for holding that view, it is not universally accepted. Sweden want just to point out that there is a line of reasoning to the effect that the provider would have a proprietary interest in the relevant assets, at least as long as the recipient has not exercised any "rehypothecation" rights and divested itself of the relevant assets.

Drafting proposal concerning 'eligible obligations'

Sweden suggests that MNA is used as a model and proposes following changes (with respect to the working group's proposal, additions are underlined):

> ***3. "Eligible obligation" means ~~an obligation~~ any agreement, contract or transaction, including any terms and conditions incorporated by reference in any such agreement, contract or transaction, pursuant to which payment or delivery obligations are due to be performed at a certain time or within a certain period of time and whether or not subject to any condition or contingency. "Eligible obligations" include: ~~arising under one of the following contracts~~ -***
>
> ***a) derivative instruments,*** *„derivative instrument means an option, forward, future, swap, contract for differences or other transaction in respect of a reference value that is, or in the future becomes, the subject of recurrent contracts in the derivatives markets.*
>
> ***b) repurchase agreements, lending agreements and margin loans relating to securities, money market instruments and units in collective investment schemes,***
>
> ***c) title transfer collateral arrangements,***
>
> ***d) contracts for the sale, purchase or delivery of***
>
> ***1. - securities***
>
> ***2 - money market instruments***
>
> ***3 .- units in a collective investment scheme***
>
> ***4 .- currency of any country, territory or monetary union***
>
> ***5 .- gold, silver, platinum, palladium, or any other precious metal***
>
> ***6 .- any other fungible commodity,*** *„Fungible commodity means a commodity that is or in the future becomes the subject of recurrent contracts in the spot, forward or derivatives markets.*
>
> ***e) any other type of contract designated to that effect under the relevant law,***

f) agreements under which a party undertakes (whether by way of surety or as principal debtor) to perform obligations assumed by another person under any agreement referred to in paragraphs [a] to [e].

Principle 8: Exception in respect of resolution of financial institutions

General

Any resolution regime for financial institutions should not be capable of overriding principle 7 about enforceability of close-out netting. Only resolution regimes of a certain standard, particularly related to global recognition, should be capable of setting aside principle 7. Close-out netting reduces risks globally on an on-going basis. Any stay can therefore have far reaching consequences several states. It is therefore import that resolution powers which can be applied on close-out netting provisions are exercised on valid grounds and in a proportionate manner. That is however depended on the standard of the particular resolution regime. Sweden believes it is necessary to state that in the principle.

Drafting proposal concerning the required standard of the resolution regime

8. Principle 7(c)(ii) is without prejudice to any legal rule that provides the competent authorities with the power, in the exercise of their resolution powers in respect of financial institutions, temporarily to stay contractual acceleration or termination rights that might arise under a close-out netting provision.

This exception applies solely to acceleration and termination rights which arise simply because of the entry of the financial institution into resolution or in connection with the exercise of any resolution powers, and to the extent that such stay does not affect the enforceability of acceleration or early termination rights not related to the entry into resolution.

<u>This exception applies solely to resolution procedures that meet certain standards in terms of global recognition.</u>

United States of America

Modern financial netting systems can boost liquidity for markets as well as facilitate economic growth and access to capital; for countries seeking economic development, creating legal structures to facilitate netting can be especially useful. A central goal of this project should be to maximize the legal certainty of market participants regarding their transactions; the Principles should encourage states to implement frameworks that provide such certainty. From this perspective, the United States offers the following comments on the current draft, in order to highlight several ways in which relatively minor changes could introduce greater clarity into what is already a very useful document. We will, of course, have additional comments to provide during the intergovernmental meeting in Rome, but would like to highlight several issues worth consideration in advance of the session.

First, while the draft strives to distinguish close-out netting from set-off, some confusion remains regarding the distinction being drawn between these two terms. As the draft Principles are not intended to provide guidance relating to set-off, that term should be more fully defined in the draft, so as to avoid an unintended implication regarding the scope of the Principles. Such a discussion, more clearly contrasting set-off with netting, could be inserted into paragraph 2, as follows (additions and deletions marked):

2. The notion of close-out netting is a relatively new addition to the legal terminology and it is not particularly well-defined. Broadly speaking, close-out netting is often understood as resembling the classical concept of set-off applied upon default or insolvency of one of the parties. Traditionally, the concept of set-off applies only to parties with mutual debts that are already payable, that have an already-determined value, and that are legally distinct. Whether set-off occurs by contract or by operation of law, the parties' existing debts are offset against each other, such that the party with the smaller debt owes nothing, and the party with the larger debt owes only the difference between the two obligations. However, close-out netting encompasses many additional elements and is functionally and conceptually different from traditional set-off. A close-out netting mechanism comes into operation either by a declaration ('close-out') of one party when a pre-defined event occurs, in particular default or insolvency of its counterparty ('termination event'), or it is triggered automatically when such an event occurs ('automatic termination'). The mechanism extends to a number, often hundreds, of ~~contracts~~ outstanding transactions between the parties that are contractually included in a netting provision. Upon close-out or automatic termination, generally all ~~contracts~~ such transactions covered are terminated and the market value of each is determined under a pre-defined valuation mechanism.

The sum value of all ~~contracts~~ such transactions is then aggregated resulting in one single payment obligation ('net amount'), which may also take into account the identity and credit standing of the determining party and other material terms of the parties' agreement. The net amount remains the only obligation to be settled and is generally due immediately after being determined, even though (unlike set-off) no debts may have been due prior to the operation of the close-out netting provision.

Similarly, in paragraph 87 of the commentary, clause (ii) ("set-off traditionally applies only to obligations flowing from the same agreement, or that are very closely connected to each other") should be deleted or softened, as it does not accurately state a characteristic of set-off in many jurisdictions.

In the commentary accompanying Principle 7, the United States would suggest several minor changes. First, paragraph 105 should be made more general; in addition to the anti-deprivation principle, other concepts such as the *pari passu* principle and ipso facto clauses should be addressed to provide additional context. Next, paragraph 107 seems inconsistent with paragraph 111, as well as unnecessary for a section focused on equal treatment of creditors, and should be deleted. Similarly, within paragraph 111, the fourth sentence (beginning with "Hence this situation") seems unnecessary and slightly confusing in context, and ought to be deleted. Finally, paragraph 115 should state that "the law remains free to determine the consequences of actual fraud"; referring to misrepresentation and intentional granting of advantages risks weakening Principle 7(c)(iv).

With respect to Principle 9, while the draft seems to take generally the right approach in substance, some restructuring could be useful to clarify the intended scope and application of the Principle. The United States suggests the following alternative version of Principle 9:

Principle 9: Governing law

(1) The law applicable to the close-out netting provision is determined by the private international law rules of the forum state. To the extent that, under the forum state's private international law rules, parties may determine by agreement

the law applicable to a close-out netting provision, such a choice of law made in a close-out netting provision is enforceable and prevails over any choice of law made in a contract covered by the close-out netting provision except as otherwise provided by the parties.

(2) The law applicable to the close-out netting provision, as determined under paragraph (1) above, determines

a) the conditions for the validity and effectiveness of the close-out netting provision; and

b) the parties and obligations that are eligible for being covered by the close-out netting provision.

(3) Notwithstanding the above, if insolvency proceedings have been commenced in respect of a party to the close-out netting provision [or a branch of that party], the laws of the forum state should also govern

a) the avoidance of a payment or other transfer of property pursuant to a close-out netting provision as a preference;

b) the avoidance of close-out netting provision as a contract in fraud of other creditors of the insolvent party; and

c) the temporary stay of a close-out netting provision or any rights thereunder as a consequence of the commencement of the insolvency proceeding.

This proposal includes several changes from the existing draft. First, an introductory sentence is added to clarify that this Principle does not itself prescribe rules for identifying the governing law for a close-out netting provision; rather, the private international law rules of the forum state determine which law governs. This sentence is followed by the concept that was placed in Principle 9(3) in the July draft—i.e., that a choice of law clause should be given effect to the extent permitted under the forum state's rules of private international law (and that such a clause in a close-out netting provision should prevail over a choice of law made in a contract covered by the provision). As in the July draft, this proposal does not contain an express reference to overriding mandatory principles or fundamental public policies of the forum as limits on choice of law, but those concepts are implicit in the reference to the forum's private international law rules and can be addressed in the commentary. Next, the proposed Principle 9(2) states two consequences of identifying the governing law, previously stated separately in Principles 9(1) and 9(2) of the July draft. Finally, the proposed Principle 9(3) generally echoes the July draft's Principle 9(4), but clarifies that the concept of avoidance as a preference applies to payments or other transfers rather than to close-out netting provisions themselves. The commentary to Principle 9 would then need to be restructured to reflect the changes represented by this approach.

Finally, as these Principles are intended to provide guidance only, rather than any type of legal obligation on states, the draft should avoid inadvertently using verbiage more appropriately reserved for legally-binding instruments. For example, the "key considerations" following Principles 1, 2, 7, 8, and 9 repeatedly use the verb "shall"; use of a non-binding verb such as "should" would be more appropriate.

COMMENTS SUBMITTED BY ORGANISATIONS

UNCITRAL

Comments relating to insolvency

The working documents point out that the UNCITRAL Legislative Guide on Insolvency Law refers to the enforceability of netting as a feature to be considered when designing insolvency law and advises that netting should be allowed under applicable insolvency procedure.

In general, the draft principles appear to be consistent with the recommendations of the Insolvency Legislative Guide, specifically:

Recognition of rights

(a) Recommendation 7: The insolvency law should address the extent to which set-off and netting rights can be enforced or protected, notwithstanding the commencement of insolvency proceedings;

Applicable law

(b) Recommendation 31: The insolvency law of the forum should apply to all aspects of the proceedings, including for example, set-off; the avoidance of certain transactions that could be prejudicial to certain parties; treatment of contracts;

Recommendation 32: Notwithstanding recommendation 31, the effects of insolvency proceedings on the rights and obligations of participants in a payment settlement system or regulated financial market should be governed by the law applicable to that system or market (also addressed in paragraph 86 of the commentary);

Recommendation 34: Exceptions to the application of the law of the forum should be clearly specified - no specific reference is made to financial contracts;

Treatment of contracts

(c) Recommendations 70 and 71: Ipso facto clauses should be unenforceable against the insolvency representative, except in the case of financial contracts;

Recommendations 72 and 73: Where a contract is to be continued or rejected it must be continued or rejected as a whole – cherry picking is not permitted;

Avoidance

(d) Recommendation 92: The insolvency law should specify the transactions that are exempt from avoidance provisions, including financial contracts;

Financial contracts and netting

(e) Recommendations 101-107:

(i) Financial contracts should be exempt from insolvency law provisions that stay the termination of contracts, limit the enforceability of automatic termination interests;

(ii) Certain routine pre-bankruptcy transfers consistent with market practice are exempt from avoidance provisions;

(iii) The insolvency law should recognize and protect the finality of netting, clearing and settlement of financial contracts through payment and settlement systems when a participant in the system becomes insolvent.

Scope of the Principles with respect to insolvency

The explanation and commentary to draft Principle 7 (paragraph 83) suggests that the understanding of which insolvency procedures should accommodate close-out netting should be very broad and reference is made to the definition of insolvency proceedings used in the UNIDROIT Geneva Convention (2009).

That definition is similar to the definition of "foreign proceeding" in article 2(a) of the UNCITRAL Model Law on Cross-Border Insolvency (2007) – the only words omitted are "pursuant to a law relating to insolvency". In the negotiation of the Model Law a conscious choice was made to limit the types of proceeding susceptible of recognition to those insolvency proceedings that may be regarded as "collective" and as satisfying the other elements of the definition in article 2(a), including that they are judicial or administrative. However, not all procedures designed to address the financial distress of a debtor are necessarily "collective". Bank and financial institution resolution regimes, for example, may not be collective in the sense typically associated with insolvency laws. What constitutes a "collective" proceeding for the purposes of the Model Law has been the subject of some judicial consideration. Differing conclusions with respect to the collective nature of the proceedings were reached in the context of recognition under the US and UK equivalents of the Model Law of an SEC receivership relating to Stanford International Bank. The English Court of Appeal found the receivership not to be a collective proceeding [2010] EWCA Civ 137 at paragraph 27], while a more recent decision in the District Court of Texas found that that receivership was a collective proceeding [In re Stanford Bank, US District Court, Northern District of Texas, 30 July 2012].

This uncertainty has led to UNCITRAL undertaking further work to provide greater certainty by way of revision of the Guide to Enactment of the Model Law. The issue has been discussed in several recent working papers (A/CN.9/WG.V/WP.95, paragraphs 18-23; and A/CN.9/WG.V/WP.99, paragraphs 16-24).

Given those considerations and the stated intention that the Principles should cover the widest range of insolvency "procedures", it may be desirable not to use the word "collective" in any explanation provided in the commentary.

We have some related reservations about the use of the words "insolvency procedures" and "insolvency proceedings". In our view, these two terms are not necessarily or always synonymous, "proceedings" typically referring to formal proceedings commenced under the insolvency law before either a court or administrative tribunal, and "procedures" covering a potentially much wider range of debt resolution mechanisms that are not necessarily conducted pursuant to the insolvency law or involve a court or other tribunal. We understand the intent to be to resolution. The latter may not all be strictly insolvency-related and may include a variety of different tools, including under some laws a modified type of insolvency or liquidation procedure. Paragraph 83 refers to "procedures" covered by the Principles, while paragraph 134 appears to equate bank resolution "procedures" with insolvency "proceedings". This explanation has the potential to create some uncertainty as to scope, especially where resolution mechanisms include both insolvency-type (typically liquidation) procedures and others, such as tools designed for early intervention to save a failing bank from becoming technically insolvent (e.g. stabilization measures under the UK banking Act of 2009).

This also leads us to the relationship between Principle 7 (c) ii and Principle 8, the latter being described in paragraph 103 as an exception to the former. However, the two Principles may not overlap as they could relate to potentially different bodies of law. Principle 7(c) refers to insolvency law, at least in so far as it applies “after the commencement of an insolvency proceeding” and refers to the effects of commencement of such a proceeding. Principle 8, on the other hand, refers to the law dealing with financial institution resolution. Resolution powers and regimes, including those that provide for liquidation of banks and financial institutions, albeit in a form that is modified from corporate insolvency regimes, tend to apply under special laws rather than the insolvency law. We note further that the commentary refers in some places to bank resolution (e.g. paragraph 90) and in others, to financial institution resolution (e.g. paragraph 103). We suggest some clarity is required as to the precise scope of the Principles, particularly as to the coverage of non-bank financial institutions.

In view of these issues, the manner in which the scope of the Principles is described and the relationship between Principles 7 and 8 could be further considered to ensure clarity.

Comments relating to the UNCITRAL Legislative Guide on Secured Transactions and the Convention on the Assignment of Receivables in International Trade

The following comments refer to the paragraphs and principles of the draft working papers.

Paragraph 9

UNCITRAL first discussed netting when it was preparing the Convention on the Assignment of Receivables in International Trade (the "Convention"; 1995-2001). At that time, UNCITRAL recognized that receivables arising from financial contracts governed by netting agreements broadly defined, with the exception of a receivable owed on the termination of all outstanding obligations (see Article 5, subparagraphs (k) and (l)) and similar transactions were of a different nature than regular trade receivables and were governed by such different rules that the Convention should not apply to those receivables (see Article 4, paragraph 2). The same approach was followed in the UNCITRAL Legislative Guide on Secured Transactions (the "ST Guide"), which excluded securities, receivables arising under or from financial contracts governed by netting agreements (with the exception of a receivable owed on the termination of all outstanding obligations) and receivables arising under or from foreign exchange transactions (see rec. 4, subparagraphs (c)-(e).

Principles 1-3

As matter of drafting, Principles 1-3 are in the nature of definitions (Principle 1) or statements as to the scope of the Principles (Principles 2 and 3, since they do not strictly “define” terms used in the Principles). Principles 4-7, in contrast, are formulated as legislative recommendations. It may be appropriate to clearly delineate the functions of these principles and use different headings.

Principle 1:

(a) The definition of the term "close-out netting provision" is formulated in more general terms than the definition of the term "netting agreement" in the Convention (see Article 5, subparagraph (l)) and the ST Guide (see terminology). This needs to be further examined to avoid any inconsistency and conflict;

(b) As mentioned above with respect to paragraph 9, both the Convention and the ST Guide apply to a receivable owed on the termination of all outstanding obligations.

Principle 3

(a) The definition of the term "eligible obligation" seems to be broader than the definition of the term "financial contract" in the Convention (see Article 5, subparagraph (k)) and the ST Guide (see terminology). This matter needs to be further examined to avoid any inconsistency and conflict;

(b) The inclusion of bank accounts in the Principles needs to be discussed, in particular as, while the Convention excludes receivables from letters of credit and bank accounts, the ST Guide does not;

(c) The possible inclusion of secured loans in the Principles and the possible impact on security interests needs also to be further considered.

Principles 4-6

Reference may need to be made in the Principles and the commentary to the United Nations Convention on the Use of Electronic Communications in International Contracts, key articles of which were also incorporated in the ST Guide (see, for example, recs. 11 and 12).

Principle 7

To the extent this Principle applies also when there is default but not insolvency, the issues mentioned above as to the scope/definitions of the Principles become very relevant and should be further considered.

Principle 9

(a) Paragraphs 1-3 could be merged and state that the matters referred to therein are to be governed by the law chosen by the parties;

(b) Limitations to freedom of choice based on public policy and mandatory law considerations may be mentioned in the commentary;

(c) If (a) and (b) are not done, paragraphs 1-3 could nevertheless be merged to refer those matters to the law governing netting agreements without specifying that law; and (d) paragraph 4 should be reformulated to deal more clearly with the impact of commencement of insolvency proceedings on the law applicable to netting (see, for example, rec. 223 of the ST Guide).