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# *Safe Harbours in Insolvency Proceedings*

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What is a 'safe harbour' in insolvency proceedings and what is its impact? How do we justify the existence of such carve-outs in insolvency laws, which apparently do violence to the very fabric and object of insolvency proceedings? Does India require such safe harbours? If so, to what extent? Time and again, these issues crop up for discussion among academics, policy makers and practitioners of insolvency law.

'Safe harbour' is often stated to be a shorthand[1] for referring to a class of transactions to which the automatic stay or moratorium[2] in insolvency proceedings will not apply[3]. Even if an insolvency proceeding is initiated against a debtor, the counterparty to a transaction protected by the safe harbour can exercise the contractual rights as if nothing has happened, in accordance with the terms of contract. It may also include the power to net and close out, if such a clause is provided in the contract. These safe harbours may in effect also immunise some transactions that would otherwise have attracted the clawback of preferential transfers. The limited purpose of this article is to explain the concept of 'safe harbour provisions' in insolvency law, and their comparative merits and demerits.

The preamble to the Insolvency and Bankruptcy Code, 2016 (Code) informs that its object is the reorganisation and the insolvency resolution of corporates, firms and individuals in a time bound manner, for maximisation of value of assets of such persons. It also intends to balance the interests of all the stakeholders. Thus, the Code aims at value maximisation of all the stakeholders and the distribution of assets in an equitable and a rule-based manner. While keeping the broad objectives so, the Code provides for some priority[4] to certain stakeholders. It also leaves scope for certain immunities[5] to certain transactions to be notified by the Central Government.

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[1] According to Black's Law Dictionary (11th ed. 2019), the term 'safe harbour' refers to (i) An area or means of protection (ii)A provision (as in a statute or regulation) that affords protection from liability or penalty. See also: Lubben, Stephen J. (2010). Repeal the Safe Harbour, *American Bankruptcy Institute Law Review*. 18, 319 ('The term 'safe harbours' is a kind of shorthand for a variety of provisions in the Bankruptcy Code that reflect the 'well-established Congressional intent to protect the derivatives markets from the disruptive effects of bankruptcy proceedings.').

[2] In some jurisdictions, it is referred to as 'automatic stay'. In the Indian context, section 14 of the Code does not provide for an automatic stay, but only a moratorium by an order of the Adjudicating Authority (AA). The section however makes it mandatory for the AA to declare moratorium on the insolvency commencement date. Moratorium ordinarily refers to the temporary suspension of legal action against a person.

[3] The term 'safe harbour' does not seem to carry the same meaning throughout all jurisdictions. See for e.g., Akhtar, Zia. (2019). Safe Harbour Reform in Australian Insolvency law and restructuring schemes under the Corporations Act. *Company Lawyer.* (explaining that in Australia, the term 'safe harbour' is not used with a meaning as is done in America under s.546(e) of the US Bankruptcy Code and is only' a quasi-defence for directors against the statutory duty to prevent a company trading while insolvent.')

[4] Sections 53 and 178 of the Code

[5] Section 14(1) of the Code; There is a significant distinction between the 'priorities' accorded in the waterfalls enumerated in the Code and the 'immunities' for transactions notified under this section. The priorities provide for a superior repayment position and places creditors in a senior-subordinate structure.

Ordinarily, the benefit of safe harbour provision is extended only to certain financial contracts, which if left to the normal rules of insolvency, can create systemic havoc. Thus, such provisions provide a privileged position to certain financial contracts. The rule of pro rata distribution among creditors of the same class is given a go-by in a safe harbour transaction.

In the United States (US), Title 11 of the U.S. Code (11 U.S.C.A. § 546)[6] provides that a trustee may not avoid a transfer that is a margin payment, or settlement payment, made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, commodity contract, or forward contract. There are other exemptions to contracts like those involving swaps and repos.

## THE NEED FOR SAFE HARBOURS

Usually, the safe harbour protection is provided to certain selected financial transactions involving financial entities. The interconnectedness of the firms and the possible fall out of a systemic failure if such transactions fail, make them specifically eligible candidates for such protection.[7] The need for safe harbours spring from a notion that completion of certain transactions are necessary for the stability of the financial system as a whole, and upsetting them on the reason of insolvency is an invitation for systemic trouble. [8]The second reason often articulated is the possible avoidance of cherry picking.[9] The safe harbour provisions allow the non-defaulter counterparty to liquidate, terminate or exercise set off in contracts, without being affected seriously by the moratorium.

In the US, safe harbour provisions were introduced because the Congress considered the need for exemption from automatic stay called for, to obviate the 'insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.'[10] In the Report[11] on the Bankruptcy Abuse prevention and Consumer Protection Act, 2005 the Committee of the House of Representatives explained the rationale for such protection very succinctly:

> 'Systemic risk is the risk that the failure of a firm or disruption of a market or settlement system will cause widespread difficulties at other firms, in other market segments or in the financial system as a whole. If participants in certain financial activities are unable to enforce their rights to terminate - financial contracts with an insolvent entity in a timely manner, or to offset or net their various contractual obligations, the resulting uncertainty and potential lack of liquidity could increase the risk of an inter-market disruption.'

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[6] 1 U.S.C. § 546(e)-(g), (j) (2012); 11 U.S.C. § 555; 11 U.S.C. § 556; 11 U.S.C. § 560; 11 U.S.C. 561; 11 U.S.C. § 741(5), (7), (8).

[7] Lubben, Stephen J. (2010). Repeal the Safe Harbours, *American Bankruptcy Institute Law Review* 18, 319, 321 ('The volatility, interconnectedness and sheer magnitude of the sums of money involved make financial firms unique.')

[8] This is not a view without critics. See for instance: Mokal, Rizwaan Jameel (2015). Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts, *Brooklyn Journal of Corporate, Financial & Commercial Law.*10,15, 15 'This view derives from the outdated "micro prudential" understanding of systemic risk, and is theoretically flawed and empirically false.'

[9] Lubben, Stephen J. (2010). The Bankruptcy Code without Safe Harbours, *American Bankruptcy Law Journal,* 123 (2010) ('The cherry picking argument rests on the belief that it is somehow inequitable for a debtor to retain favorable derivatives while rejecting unfavorable contracts'.)

[10] H.R. Rep. No. 97-420, at 1 (1982).

[11] Report on H.R. 4393 - Quoted in H.R. Rep. No. 109-31, pt. 1, at 20 n.78 (2005) (August 28, 2019). https://www.congress.gov/109/crpt/hrpt31/CRPT-109hrpt31.pdf.

As noted by the Second Circuit Court[12] in the United States:

> ' The purpose of the 'safe harbour' statute, 11 U.S.C.A S. 546(e) prohibiting bankruptcy trustees from avoiding transfers that were margin or settlement payments made by or to financial institutions, is to protect the market from systemic risk and allow parties in the securities industry to enter into transactions with greater confidence.'

While there is a large quantity of academic literature available on the subject, explaining the need for safe harbour provisions, there is an equally forceful view that such safe harbours have not resulted in any kind of advantage to the financial system. The critics argue that instead of advancing the cause of system stability, it has only destabilised the system as a whole.

## PROVISIONS OF THE CODE

Section 14(1) of the Code states that on the insolvency commencement date, the Adjudicating Authority shall by order declare moratorium for prohibiting certain transactions, *viz*.:

> '(a) the institution of suits or continuation of pending suits or proceedings against the corporate debtor including execution of any judgment, decree or order in any court of law, tribunal, arbitration panel or other authority;
> (b) transferring, encumbering, alienating or disposing of by the corporate debtor any of its assets or any legal right or beneficial interest therein;
> (c) any action to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property, including any action under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002;
> (d) the recovery of any property by an owner or lessor where such property is occupied by or in the possession of the corporate debtor.'

Section 14(3) however states that these prohibitions will not apply to such transactions as are notified by the Central Government. By an amendment that came into effect on June 6, 2018 it has been declared by the statute that the moratorium will not affect a surety in a contract of guarantee to a corporate debtor. The Central Government has not yet notified any such transaction so far as exempt.

The order of moratorium is intended to preserve the value of the going concern surplus. A cursory glance at the provision reveals that it operates only as a bar against third parties from proceeding against the corporate debtor through institution of proceedings or continuing with the already initiated suits. It does not debar a corporate debtor from proceeding against a third party who owes a debt to it. At the same time, the statute proscribes the corporate debtor from transferring, encumbering, alienating or disposing of its assets. Further, any action by creditors to foreclose, recover or enforce any security interest created by the corporate debtor in respect of its property is barred during this period.

## SAFE HARBOURS: FOR AND AGAINST

### Arguments in Favour

There are many justifications proffered for providing a special dispensation to certain financial contracts like derivatives and repos:

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[12] *Tribune Co. Fraudulent Conveyance Litigation,* 818 F.3d 98 (2d Cir. 2016).

- One of the most prominent arguments in favour of bringing in some safe harbour for financial contracts is the possible domino risk, i.e., the possibility of a ripple effect on the system, if a significant participant fails. This line of view proceeds on the basis that there is significant interconnectedness among transactions in financial contracts and the failure of one should not be allowed to snowball into a systemic failure.
- Unfair cherry picking of the contracts could be avoided.
- It enhances ability to achieve quick closeout netting, and thus reduces risk.
- The safe harbour makes parties more willing to enter into contracts falling within its ambit, which would minimise the costs.
- Some commentators tend to think that development of markets like derivatives would simply be impossible without the protection afforded by the safe harbours.[13]

**Arguments Against**

On the face of it, the safe harbour provisions appear to run against the basic philosophy of insolvency action. A forceful and appealing argument against safe harbours is that they negate the underlying philosophy of insolvency proceedings. [14] The basis of equity in an insolvency proceeding gets distorted and a group of transactions which are falling within the ambit of safe harbour gets a preferential treatment over others. This may act as a disincentive for others. There are certain other factors also which are relevant in this context:

- As a result of the protection accorded by the insolvency regime, the creditor may not insist on appropriate collaterals or may not have appropriate incentives for insisting so.
- If the insolvency law provides immunity to the creditors, they may not do the pre-lending due diligence effectively. Further, monitoring of the assets created through lending may be shoddy, since the bankruptcy may not affect them.
- The incentive for diversification which a normal creditor would have, may not be there with a creditor who enjoys the safe harbour protection. Such a behavior may be the result of a thinking that the creditor is protected even otherwise.
- The usual rationing of credit will be absent. There may be a tendency on the part of the creditor to lend more at a lower cost. This is of course both an advantage and a disadvantage.
- The other creditors will not have a share to the extent of the claim of the creditor in the safe harbour. Thus, non-safe harboured creditors are providing a subsidy to the safe harboured creditors.[15] This can lead to the insolvency of the non-exempt creditors in certain situations.
- Creditors will engage in an opportunistic behaviour and take away the assets of the debtor, which would be ultimately detrimental to the debtor. In an insolvency

[13] See: Edwards Franklin R. & Morrison, Edward R., Derivatives and the Bankruptcy Code: Why the Special Treatment? *Yale Journal on Regulation* 22, 91('A counterparty is more willing to enter a derivatives contract with a firm (or will enter at a lower price) if it can minimize the costs it may incur if the firm suffers financial distress.')

[14] Lubben, Stephen J.,(2017). Subsidizing Liquidity or Subsidizing Markets? Safe Harbours, Derivatives and Finance. *American Bankruptcy Law Journal,* 91, 463(arguing generally that, in bankruptcy, preservation of 'going concern surplus' outweighs most other concerns, the safe harbour reverses the configuration, offend the theoretical base of collective resolution of financial distress, and imposes a cost on society at large.)

[15] Vasser, Shmuel & Kerfoot. Matthew K., (2010). Preferential Treatment of Derivative Contracts - Saviour or Scourge? 30 *Futures and Derivatives Law Report 30,* 11('When certain transactions are afforded safe harbour treatment, the Code effectively subsidizes such transactions by reducing the risk - i.e., the cost - of these transactions.')

situation, the debtor has very little effective bargaining power.

- The potential for an effective reorganisation or resolution is thwarted to a great extent because of the power to withdraw the collateral by the creditor in safe harbour.
- Obviously, in the area of design of financial products and contracts, participants would concentrate more on products which would have the safety of safe harbour protection. Potential lenders will have a tendency to design credit products in such a way that they will fall within safe harbours. If the relevant legal system does not allow a judicial scrutiny of the economic substance of the transaction, it becomes easy for the creditors to bring a transaction within the fold of safe harbours merely by naming them with that of an instrument or contract specially protected.
- Once a favourable treatment is given to a certain set of transactions, there is a tendency to broaden the scope and ask for more. In the US, the safe harbour protection was much narrow in scope when started. But, over a period of time, the scope got so very wide.

## LOOKING FORWARD

Where should we proceed from here and what are the types of transactions that the country should consider for bringing within the safe harbour? These are not questions with easy answers. But, that is no reason not to ponder over them.

One word of caution would be apposite here. As is seen under the U.S. Bankruptcy Code, once brought into effect, there is always a tendency to demand, and consequently expand, the scope of safe harbour provisions. Keeping a close watch on the issue therefore gains importance. It is also extremely important to craft safe harbours keeping in mind the potential imbalance it creates. It should not be too wide or too narrow. Striking a balance is definitely bound to be a tough exercise. It is necessary to make an assessment of the costs and benefits and the collateral effects, in deciding how broad or narrow should be the safe harbour.

Another issue of significance is whether non-financial institutions should be allowed the benefit of safe harbour, as the argument of systemic risk may not be forceful there. Unless, the exemptions are limited to transactions involving financial entities, the avowed object will not be achieved. So is the issue whether *ipso facto* contractual clauses (clause that allows termination on filing of insolvency petition) should be permitted or not. There can be questions as to whether they should be extended to contracts executed outside a recognised stock exchange.

Again, a debatable and contentious issue with respect to safe harbours would be the decision whether the exemption should be based on form or substance.[16] Merely by adding the label, whether parties should be able to take benefit of the safe harbour provisions? Or should the participants be allowed to run the risk of a regulator or a court of law recharacterising the transaction, apparently depriving the benefit to a party entering into a *bonafide* transaction?

It is beyond cavil that wrong immunities have the potential to destroy the value of the debtor firm.[17] Therefore, while crafting a policy on immunity from the moratorium, one has to

[16] Chung., John J. (2010). From Feudal Land Contracts to Financial Derivatives: The Treatment of Status through Specific Relief.*Review of Banking and Financial Law* 29,107. ('If a party to a contract calls it a derivative, then it is a derivative, and any attempt by a seasoned bankruptcy judge to determine the true substance of the contract will be severely limited.')

[17] Jameel Mokal, Rizwaan (2015). Liquidity, Systemic Risk, and the Bankruptcy Treatment of Financial Contracts. *Brooklyn Journal of Corporate, Financial & Commercial Law,*10(15), 32–33. (stating that the primary cost of ill-chosen priority rules is the misallocation of value from the bankruptcy estate but the effect of wrong immunities is not merely the misallocation but the *destruction* of value from the estate.)

be careful about the possible negative impact it can make, along with the expected benefits. An equally important aspect is the choice of words in the exemption notification. Going by the settled canons of statutory construction, an exemption being a deviation from the general rule, has to be interpreted strictly.[18] This would require paying enormous attention to the choice of words in the notification. A loosely worded or generalised notification[19] may create more uncertainty and invite litigation.

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[18] *M.A.C. Laboratories (P) Ltd. v. Collector of Central Excise*, AIR 1995 SC 510.

[19] For instance, a general description may lead to disputes on the appropriate classification and this may be more acute when hybrid instruments are involved.