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Preliminary draft Report on

The need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution

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 The present paper is partly built on and comprises the substance of my two earlier papers on netting (WM Zeitschrift für Wirtschafts- und Bankrecht 64 (2010), 1965 et seqq. and Institute for Law and Finance (Frankfurt) Working Paper Series No. 116).

‘Close-out netting is a process intended to reduce exposures on open contracts if one party should become insolvent or a like event occurs before the settlement date. As in this case, the agreement typically provides that, on an event of default in relation to one party, the other party can terminate all outstanding contracts between the parties, calculate the losses and gains on each contract and then set them off so that only a balance is owing. These losses and gains are usually the difference between the agreed price of each transaction concerned and the market price at termination - essentially compensation for the termination calculated on damages principles. It is often agreed that the parties will account to each other for losses and gains, as here. These contracts are routine in financial markets and elsewhere.’

Commissioners for Her Majesty's Revenue & Customs v Enron Europe Ltd
[2006] EWHC 824 (Ch), [2006] B.C.C. 953, at [20] per Lightman J.

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Summary

This study examines the need for and desirability of harmonising, on a global scale, the commercial and insolvency law rules protecting netting agreements in the event of the insolvency of one of the parties. It concludes that harmonisation is necessary having regard to the existence of legal uncertainty in a considerable number of cross-jurisdictional cases.

In the 1st Part, this study demonstrates that general domestic law, particularly in the areas of commercial and insolvency law, fails to provide sound and predictable legal results in cross-jurisdictional cases dealing with the enforceability of netting in insolvency. The analysis leads to the result that harmonisation is necessary in respect of

- the definition of netting;
- the legal mechanism protecting netting in the insolvency;
- the lists of eligible parties and eligible financial contracts;
- formal requirements; and,
- the relevant conflict-of-laws rules.

The 2nd Part assesses the impact of new regulatory tools in the context of bank resolution, such as transfer orders and moratoria, on netting. It comes to the conclusion that these tools are able to disrupt the enforceability of netting on the one hand, and their efficacy itself might be threatened by the operation of netting agreements on the other. This part concludes that this effect can only be fully avoided by

- affording cross-border effectiveness to these regulatory powers, including the relevant ancillary tools (which is within the ambit of regulatory and supervisory co-ordination); and,
- harmonising the legal framework of netting along the lines set out in the 1st Part.

Thus, both parts make a very strong case for harmonisation.

The 3rd Part strives to give guidance on how harmonisation of netting legislation could happen.

- In terms of content, it provides some preliminary principles for consideration.
- In terms of process, it recommends a two step approach. First, a non-binding set of detailed principles pertaining to the areas of commercial and insolvency law would enhance the cross-jurisdictional status of netting legislation. On that basis, in a second step, the necessity of a binding instrument, i.e. an international Convention, addressing specific and isolated issues would be assessed.

Some remarks on the objective of this study

This report merits three introductory remarks in order to avoid misunderstandings:

First, it was difficult to select the jurisdictions on which concrete analysis and examples would be based. There are probably more than one hundred jurisdictions that regulate financial markets in one way or another, and they are all relevant to a project about harmonising the laws on netting. Therefore, I had to the limit the analysis to a relatively general level. However, the analysis also needed to be based on country-examples, which were chosen, depending on the originality of the relevant legal approach, the importance of the financial market, or simply the availability of data. It is also worth noting that for the purposes of this study it was not necessary to provide a comprehensive picture of every jurisdiction's regulatory approach – what is relevant is the principle.

This leads to the second point. This study is about common principles found in the various laws, not about the details of domestic legal concepts. Specific illustrations based on actual domestic laws are rarely given. It would be an impossible task to reflect all relevant legal concepts of all the jurisdictions affected by this analysis. For example, I generally refer to 'insolvency', disregarding that the correct term some jurisdictions would be 'bankruptcy', 'receivership' or a similar concept.

This simplification is a crucial prerequisite for the neutral search of legal incompatibilities. For the same reason, and this is the third point, I tried to strip this report of any language that is proprietary to the business side of the financial markets. For example, I refer to 'derivatives' instead of 'swaps', to 'netting agreement' instead of 'master agreement', and to 'financial contracts' instead of 'transactions'.

Introduction – netting as a legal concept for the financial market[1]

1. Financial institutions and other participants in the financial market in their daily operations apply a variety of mechanisms designed to reduce their credit risk exposure. First, they use a set of arrangements that might be termed 'classical' types of security interest provided by the law and widely used in commercial practice, in particular different kinds of personal security interest (e.g. 'bailment', 'guarantee', etc.) or security interests established over movable, immovable or intellectual property (e.g. 'pledge', 'charge', 'hypothec', 'mortgage', 'repo', etc.). In the financial market, security interests created over cash, securities or claims exist in a variety of legal setups, and the legal arrangements often resemble, at least on the surface, the afore-mentioned security interests applied to the world of movables, e.g. pledge of cash, securities or claims.

2. The modern financial market, in addition to the techniques listed above, has developed entirely new approaches able to reduce market participants' credit risk exposure, amongst them netting arrangements, i.e. the contractual arrangement between counterparties to apply netting in respect of their mutual rights and obligations. The analysis that follows focuses on netting, or, more precisely, on close-out netting.

3. The notion of netting is a relatively new addition to the legal terminology2 and it is not particularly well-defined. Broadly speaking, it is often understood that netting resembles the classical concept of set-off known since ancient Roman times.3 However, netting, especially in the form of close-out netting, encompasses important additional elements that result in netting being considerably different from traditional set-off.

Example 1*: A-Bank and B-Bank do a great deal of business with each other. There are numerous mutual payment and delivery obligations (e.g., interest payments, delivery of foreign currencies, claims to return of collateral, pledges over securities) resulting from various kinds of financial contracts. In order to avoid one party from being infected by the financial problems of the other, the parties conclude a close-out netting agreement. Under this agreement, in the event of default by either party to meet any of its obligations vis-à-vis the other, all mutual rights and obligations are deemed to be immediately due. Obligations in kind (delivery of, e.g., foreign currency) are transformed into a payment obligation, under a predetermined valuation mechanism. The mutual rights and obligations are then computed so as to result in a single net payment obligation of one of the parties to the other party. This is the only obligation that remains to be settled.*

4. Netting arrangements are widely used in the financial market by private sector entities, in particular banks, but also private non-financial institutions. In the public sector, entities such as, especially, central banks and supranational financial institutions such as development banks make use of netting arrangements. Regulatory authorities (most recently, the *Cross-border Bank*

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[1] I am grateful to José Angelo Estrella Faria, Francisco José Garcimartín Alférez, Holger Hartenfels, Klaus Löber, Hans Kuhn, Sharmini Mahendran, Guy Morton, Ed Murray and Peter Werner for their valuable comments on various parts of the study. I am also grateful to Joris Latui, Research Assistant of the *Law and Financial Markets Project* of the LSE, for his efficient and immaculate help.

[2] In 1989, the Group of Experts of the Central banks of the Group of Ten Countries (the predecessor of the Basel Committee) issued the *Report on Netting Schemes,* (hereinafter 'Angell-Report on Netting Schemes'), www.bis.org/publ/cpss02.pdf. This report was probably the starting point for the prevalence of the concept and terminology of netting. Its findings are still valid. Simultaneously, 'netting' started to appear as a concept in legislative acts, albeit very few. Later on, 'close-out netting' became widely used under the master agreements provided by market associations, in particular ISDA, ICMA, EBF and others, *cf.* page 12.

[3] *Cf.* the historical overview by J. Dalhuisen, *Transnational comparative, commercial, financial and trade law*, Vol. 3, 4th ed. 2010, p. 340 *et seq.*

Resolution Group of the Basel Committee on Banking Supervision) encourage the use of such netting arrangements because of their beneficial effects on the stability of the financial system.[4]

I. Basic legal underpinnings of netting

A. Netting and master agreements

5. The majority of financial market transactions, for example derivatives, foreign exchange, securities lending and repurchase contracts, are concluded using standard documentation ('master agreements'[5]). A number of master agreements are available for the various types of financial contract and for various jurisdictions.

6. For cross-border use, the International Swaps and Derivatives Association (ISDA) Master Agreement is the quasi standard for derivatives transactions from the world-wide perspective, whereas repurchase agreements are usually bundled under the International Capital Market Association (ICMA) Global Master Repurchase Agreement; in Europe, the multi-product European Master Agreement for Financial Transactions (EMA) of the European Banking Federation is widely applied. These agreements are accompanied by a set of optional annexes covering different types of financial contract. In addition, there are various other master agreements for specific sectors or jurisdictions, e.g. the New York Foreign Exchange Committee International Foreign Exchange Master Agreement (IFEMA); the International Foreign Exchange and Options Master Agreement (FEOMA); the International Securities Lending Association (ISLA) Global Master Securities Lending Agreement; the Convention-Cadre relative aux Opérations de Marché à Terme of the French Banking Association; the Contrat-Cadre de Prêts de Titres of the Association of French Securities Dealers; the Rahmenvertrag für Finanztermingeschäfte, the Rahmenvertrag für Pensionsgeschäft, and the Rahmenvertrag für Wertpapierleihgeschäfte of the German Banking Associations; the Contrato Marco de Operaciones Financieras of the Association of Spanish Private Banks; the China Inter-bank Market Financial Derivatives Transactions Master Agreement of the National Association of Financial Markets Institutional Investors (NAFMII); the Standard Documentation for Derivatives Transactions on Financial Markets of the Association of Russian Banks (ARB); the Brazilian Contrato Global de Derivados.

7. Master agreements are not tied to any one particular applicable law, but English or New York law is usually chosen for cross-border agreements. Japanese, Hong Kong, Swiss, French, German, Spanish and Italian law have some regional importance. The European Master Agreement was geared from the outset to multi-jurisdictional (and multilingual) use and is concluded under one of the laws of the European Union Member States.

8. Clauses on netting often form a core part of master agreements but, even though they are included in such standardised contracts, netting agreements nevertheless are still contracts that from a legal point of view could be negotiated separately and privately between the parties. Hence, the fact that netting agreements are often part of master agreements does not affect the results of this analysis in any way. This paper therefore uses the term 'netting agreement' on the understanding that netting agreements in a great majority of cases form part of a master agreement.

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[4] *Bank for International Settlements/Basel Committee on Banking Supervision*, Report and Recommendations of the Cross-border Bank Resolution Group, March 2010, http://www.bis.org/publ/bcbs162.pdf?noframes=1 (hereinafter: Basel Committee CBRG Report), Recommendation 8, p. 36 *et seq*.

[5] Concise description: H. Ekué, *Lehman Brothers: contrepartie dans des opérations sur produits dérivés,* R de Droit bancaire et financier, 5 (2009), section 1-A.

B. Set-off and the different types of netting

9. The notions of netting and its sub-categories settlement netting, novation netting and close-out netting are terms developed by the market. There is some common understanding as to typology that is universally used. However, the market generally considers the issue of netting in functional terms (termination of contracts, computation of an aggregate amount, etc.), whereas from a legal perspective borderlines can be blurred. The background is that the functionalities of 'netting' are often mirrored in legal terms by partial reference to existing concepts, notably set-off, *cf. infra,* p. 20).[6] Apart from the distinction between the functional and legal perspectives, the categorisation of netting is further complicated by the fact that the parties' agreement is capable of designing particular set-off or netting mechanisms or combining them with each other. Thus, the standard categories described below reflect only basic patterns, notably as shaped by the wide application of master agreements.

Set-off

10. Classical set-off is different from what is generally understood by netting. Yet the term set-off is often used as an interface to describe the functions of netting and to transpose them into law (notably the function of computation of a net amount). Some laws even treat netting as a category of set-off. Set-off is the classical means of discharging mutual obligations, mostly (but not necessarily) payment obligations under which a debtor sets off a claim owed to it by its creditor against the debt, resulting in a single obligation equal to the difference between both claims. Set-off is generally allowed under statutory provisions and can be extended or altered by contract.[7] It is allowed to the extent that both claims are due; some jurisdictions require that they stem from the same contractual relationship or are somehow 'connex'. In the event of the insolvency of one party, set-off is allowed in some jurisdictions. In others, it is mandatory and occurs by operation of law. In a third group of jurisdictions, insolvency set-off is restricted or prevented.

Settlement netting

11. The instrument of settlement netting is the computation by contract of equivalent fungible claims under executory contracts, e.g. for commodities or foreign exchange, where the mutual deliveries fall due for payment or delivery on the same day. The background is that it is sometimes difficult to arrange simultaneous payments. The purpose of settlement netting therefore is to reduce settlement risk[8] (which forms part of the overall counterparty risk) as the only remaining obligation for the parties is to settle the net balance. Settlement netting is different from 'classical' set-off because it applies to deliveries under contracts that are still to be performed, whereas set-off traditionally applies to debts that are due.[9]

Example 2 *(after P. Wood, ibid.): Y-Bank sells X-Bank GBP 66 for USD 100. A few days later, Y-Bank sells X-Bank USD 100 for GBP 67, to be paid on the same day as the first contract. If, on the day Y-Bank pays its GBP 66 and USD 100 under the two contracts, X-Bank becomes insolvent before paying its USD*

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[6] *Cf. European Financial Markets Lawyers Group (EFMLG)*, Protection for bilateral insolvency set-off and netting agreements under EC law, October 2004, [15] and [111] in relation to EU law applicable outside the banking sector: the use of the term 'set-off' in the EU Insolvency Regulation and its subsequent divergent implementation in the EU Member States has created deep uncertainty as to whether the Directive's set-off protection (Article 6) encompasses elements that go beyond classical set-off, in particular close-out netting.

[7] J. Dalhuisen, *Transnational comparative, commercial, financial and trade law*, Vol. 3, 4th ed. 2010, p. 344: it can be altered as to connexity, acceleration of maturity, set-off of non-congeneric claims, retroactivity beyond insolvency.

[8] *Cf.* on the details of settlement risk: Agnell-Report, p. 9.

[9] P. Wood, Set-off and netting, derivatives, clearing systems, 2007, section 1-028.

100 and GBP 67, Y-Bank has lost those gross amounts. But if the reciprocal amounts were netted when the second contract was entered into, Y-Bank's exposures would be GBP 1.

12. Settlement netting does not itself bring about a contractual consolidation of the separate accounts which have given rise to it; it takes place when payments fall due, and it is not until the completion of payment that the obligations under those contracts are discharged.[10] Settlement netting occurs in a multilateral context (settlement systems for payments or securities operated by stock exchanges, central securities depositories or central counterparties[11]) and is also found in bilateral relations where bundles of financial contracts between two parties are settled without the intervention of a market infrastructure, in particular in the case of derivatives contracts, securities lending or repo (*cf. infra*, p. 15), and settlement netting regularly figures in standard documentation, e.g. European Master Agreement, section 3(4); ISDA Master Agreement, section 2(c).

Netting by novation

13. Netting by novation is a specialised form of settlement netting and employs a mechanism quite different[12] from classical set-off. Two (or more) entire contracts (not just payment obligations) of the same type are terminated and replaced by a new contract of exactly the same type that mirrors only the net balance of the terminated contracts.[13]

Example 3*: A-Bank buys from B-Bank USD 100 for EUR 75, payable on 1st September. Subsequently, B-Bank buys from A-Bank USD 200 for EUR 140. The parties terminate both contracts and replace them by an agreement under which B-Bank receives on 1st September from A-Bank USD 100 against payment of USD 65.*

14. Often, this type of netting is agreed upon at the beginning of the lifetime of a set of contracts. In the case of 'swaps' in particular, the parties agree from the outset that they will only owe each other a single net payment, replacing the two cross-claims.[14] Netting by novation is basically confined to the foreign exchange market. It was used to reduce capital requirements under the 1988 version of the Basel Capital Accord, whereas the 1994 version allowed for the less cumbersome close-out netting. Novation netting therefore does not play a prominent role in the financial market.

Focus: Close-out netting

15. This report focuses on the enforceability of close-out netting, as exemplified in Example 1, *supra*. The mechanism is also called default netting and forms a core part of standard market documentation, as for instance the ISDA Master Agreement or the European Master Agreement.[15] Close-out netting is the form of netting envisaged by Articles 31 and 33 of the Geneva Securities Convention and underlies Recommendations 101-107 of the UNCITRAL Legislative Guide on Insolvency Law. However, the enforceability of close-out netting poses by far the most significant problems as compared to settlement or novation netting.

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[10] R. Goode, *Commercial* Law, 2010 (ed. E. McKendrick), p. 511.

[11] In the 27 EU Member States, this issue is addressed in the *Settlement Finality Directive* which defines netting as the conversion into one net claim or one net obligation of claims and obligations resulting from transfer orders which a participant or participants in a settlement system either issue to, or receive from, one or more other participants, with the result that only a net claim can be demanded or a net obligation be owed.

[12] Cf. in detail J. Dalhuisen, Transnational comparative, commercial, financial and trade law, Vol. 3, 4th ed. 2010, p. 346.

[13] *Cf.* R. Goode, *Commercial* Law, 2010 (ed. E. McKendrick), p. 510.

[14] J. Dalhuisen, Transnational comparative, commercial, financial and trade law, Vol. 3, 4th ed. 2010, p. 394.

[15] European Master Agreement, sections 6 and 7; ISDA Master Agreement, sections 5 and 6.

16. Under a close-out netting agreement[16], the netting mechanism comes into operation either by a declaration ('close-out') of one party upon the occurrence of a pre-defined event, in particular default or insolvency of its counterparty ('termination event'), or it is triggered automatically upon the occurrence of that event ('automatic termination').[17] The mechanism extends to a bundle of financial contracts between the parties that are contractually included in the netting agreement. Upon close-out or automatic termination, all non-performed[18] contracts are terminated and the market value of each contract is determined under a pre-defined valuation mechanism. The aggregate value of all contracts is then computed so as to result in one single payment obligation ('net amount').[19] This obligation remains the only obligation to be settled and is generally due immediately after the net amount is determined.

17. Where close-out netting occurs in the context of the insolvency of one of the parties, and the net amount is positive for the solvent party, that party is paid from the insolvency estate as an unsecured creditor and may therefore lose some or all of its claim. Where the net amount is positive for the insolvent party, the solvent party must pay the insolvency estate.

C. Solvent and insolvency netting; termination event

18. Close-out netting can occur both in situations where both parties are solvent and in the event of the insolvency of either, since it is the parties to the netting agreement themselves that determine the trigger for the operation of the mechanism, the 'termination event'. This event may consist, in particular, in one of the parties defaulting on one or more of its obligations, or in its filing for insolvency, in the installation of a state administrator or a similar intervention by the public authorities, or in the opening of an insolvency proceeding or an administration, resolution or restructuring procedure. Netting agreements additionally include external circumstances as termination events, such as the objective impossibility of performing an obligation under one of the financial contracts, or the downgrading in credit rating of one of the parties after its merger with another company. Given the range of potential termination events, it becomes evident that netting agreements can be designed to apply to both pre-insolvency and insolvency situations.

19. A netting agreement will in general be subject to the principle of the parties' freedom of contract, and there are no particular obstacles to its enforceability as long as both parties are solvent. However, the situation is totally different in the event of *insolvency* of one of the parties. Public policy in relation to insolvency proceedings traditionally prevented the enforceability of netting in that scenario, and this principle is still applied in certain jurisdictions. The 1st part of this report focuses on the enforceability of insolvency close-out netting.

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[16] Cf. Angell-Report on Netting Schemes, p. 12; J. Dalhuisen, Transnational comparative, commercial, financial and trade law, Vol. 3, 4th ed. 2010, p. 294.

[17] In some jurisdictions, in the event of insolvency of one party, identical effects are achieved by mandatory operation of law, even if a netting agreement existed; cf. p. 40, infra.

[18] Or 'executory' contracts: in detail P. Wood, Set-off and netting, derivatives, clearing systems, 2007, section 1-032 et seqq.

[19] Cf. the central clauses of both aforementioned master agreements (capitalised terms are defined terms under the respective agreement):

'In the event of a termination pursuant to this Section […], neither party shall be obliged to make any further payment or delivery under the terminated Transaction(s) which would have become due on or after the Early Termination Date or to provide or return margin or collateral which would otherwise be required to be required to be provided or retuned under the Agreement and related to the terminated Transaction(s). These obligations shall be replaced by an obligation of either party to pay the Final Settlement Amount in accordance with Section […].' (European Master Agreement, section 6(4));

'Upon [close-out], no further payments or deliveries […] in respect of the Terminated Transactions will be required to be made […].The amount, if any, payable in respect of an Early Termination Date will be determined pursuant […].' (ISDA Master Agreement, section 6(c)).

D. Bilateral settlement and central clearing

20. Financial contracts concluded between two counterparties may be settled either bilaterally, between the parties themselves, or through a central entity interposed between the parties.[20] Close-out netting (as well as settlement netting) is *equally important* in both scenarios.

21. Bilateral settlement has so far been tacitly assumed in this analysis. It mirrors the classical two-party situation where there are numerous mutual delivery and payment rights and obligations, some of which are due and others that are still to be performed in the future. In the course of regular business, payment obligations that are due may be subject to set-off and settlement netting. In the event of default, close-out netting may occur.

22. This study uses the term 'central clearing' as shorthand for the functionalities of central counterparties, net payment systems and clearing and settlement systems in general. All these infrastructures ensure that the settlement and counterparty risk, though it exists from a contractual point of view between the parties, is concentrated on a central entity and is permanently kept to net exposure. Central clearing applies by virtue of contractual agreements between market participants or as a legal requirement.

23. The arrangement achieves the aforementioned result by interposing the central entity between the parties to every financial contract, so that it becomes 'buyer to every seller and seller to every buyer'.[21] The net risk exposure is calculated on a bilateral basis, so that each participant's exposure exists exclusively against the central entity. This applies both to regular business scenarios, where settlement netting mechanisms apply, and to the default situation, where close-out netting arrangements may be operated. Thus, given that, from a legal point of view, central clearing remains strictly bilateral, considerations in respect of bilateral settlement generally apply to central clearing.

E. Multi-branch netting

24. Typically, financial market participants have several branches in jurisdictions other than that of their head office. A netting agreement may extend to the entirety of financial contracts entered into (with the same counterparty) by the head office and its foreign branches. Branches, as opposed to subsidiaries, are not legally independent from the head office, i.e. branches and the head office form part of the same legal entity. As long as a multi-branch entity is not insolvent, multi-branch netting would probably be recognised by the legal framework to the same extent as is netting generally.

25. However, as soon as a multi-branch party becomes insolvent, everything will depend on whether there is a single insolvency proceeding covering both the head office and the branches (governed by the insolvency law of the head office) or whether there are separate proceedings over some or all the branches.[22] In the latter case, ring-fencing may occur, with the local insolvency administrator preventing claims and assets from being attributed to the head office estate or to the estate of another branch (*cf.* the scenario 'Transfer, territoriality and foreign branch', *infra*, p. 55).

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[20] *Cf.* in general: B. Geva, *The Clearing House Arrangement*, 19 Canadian Business Law Journal 138 (1991), pp. 138-162.

[21] K. Löber, *The developing EU legal framework* for clearing and settlement, ECB Legal Working Paper Series No. 1 (2006), p. 6.

[22] Cf. UNCITRAL Model Law on Cross-Border Insolvency, in particular Art. 20; EU Directive on reorganisation and winding up of credit institutions, in particular Art. 10.

F. Multilateral netting

26. The term 'multilateral netting' is not well-defined and is often used to describe central clearing, as set out above. However, truly multilateral netting refers to a very specific situation. The basic scenario, which is applied to some extent in some payment systems, consists of a number of independent financial market participants who compute their mutual exposure on a multilateral basis, employing functionalities similar to those used in close-out netting, capped by a system of mutual cross-assignments.

Example 4*: A-Bank, B-Bank and C-Bank conclude a multilateral netting agreement under which claims existing on a bilateral basis are replaced by net claims calculated on a multilateral basis. At a given point in time, A owes EUR 20 to B; B owes EUR 60 to C; and C owes EUR 40 to A. Following their agreement and after cross-assignment and computation, these claims are to be settled by A paying nothing, B paying EUR 40 to C, and C paying EUR 20 to A.*

27. This shows that multilateral netting can be used as a tool to circumscribe the exposure of one market participant *vis-à-vis* a multitude of other, independent market participants, typically a bank managing its risk exposure under one single netting agreement against several entities belonging to the same group of companies (therefore this form of netting is also called 'cross-affiliate netting'). On the face of it, this situation resembles the multi-branch netting technique, with one important difference in that the affiliates are legally independent from each other.[23]

28. The legal difficulties of multilateral netting are apparent: first, the contractual agreement is highly complex, using a system of mutual cross-assignments and cross-guarantees; secondly, the recognition of a multilateral netting agreement by the applicable insolvency law depends on whether netting in general and multilateral netting in particular are legally recognised; thirdly, to the extent that cross-assignments are only agreed on an *ad hoc* basis in the event of default of one of the parties, the insolvency administrator may subsequently avoid these agreements as unjustified preferences; fourthly, in a cross-border situation, the applicable insolvency laws may exacerbate the aforementioned difficulties. It is these difficulties that are contributing to the growing use of central clearing facilities, as described above.

II. Why enforceability of netting agreements matters

29. The beneficial effects of close-out netting are particularly palpable in the event of the insolvency of one of the parties. However, these benefits can only materialise if the legal effects stipulated in a close-out netting agreement are recognised by and *enforceable* under the applicable insolvency law.

30. Gross exposures between different market participants, for instance between two financial institutions operating worldwide, can be enormous. Close-out netting is an instrument that allows the institutions' risk situation to be assessed on the basis of net exposure. Therefore, close-out netting has an application in risk management and in the calculation of capital requirements, since the net exposure in the event of default of the counterparty is often only a small fraction of the gross exposure.

31. Against this background, it is obvious why netting is regularly used in certain business areas such as settlement of financial instruments, high frequency trading between two counterparties, repurchase transactions and the derivatives business – here, the difference between gross and net exposure is particularly high. Yet netting is also used in other business areas, e.g. as part of

[23] Cf. H. Ekué, Lehman Brothers: contrepartie dans des opérations sur produits dérivés, R de Droit bancaire et financier, 5 (2009), sections B1-B2.

wholesale contracts relating to the delivery of gas or electricity. Likewise, public entities, when using interest rate derivatives to hedge their interest rate risk, include netting agreements in the contractual framework with a view to reducing the counterparty risk.

Some market data

32. The Bank for International Settlements provides data[24] illustrating the effect of close-out netting: the notional amount of all types of OTC contracts stood at approximately USD 605 trillion at the end of June 2009. The gross market value of these contracts, i.e. the cost of replacing all of them by equivalent contracts at the market price, was USD 25 trillion. This amount corresponds to the market risk inherent in these contracts, i.e. market participants were, on an aggregate basis, exposed to each other by that sum. At the same time, aggregate actual credit exposures of market participants, i.e. the remaining credit risk taking into account legally enforceable netting agreements, amounted to USD 3.7 trillion, which represents a risk reduction of 85%.[25]

The individual perspective: a competitive advantage

33. Where both parties benefit from enforceable netting agreements, they can enter into financial contracts with each other and so take advantage of that risk reduction. The beneficial effect mainly consists in a reduction of counterparty risk on the one hand, and a more favourable position in terms of the underlying capitalisation on the other hand. If one party is subject to a law that is unclear, indifferent or even unfavourable to netting arrangements, the conclusion of a netting agreement, if at all possible, does not carry similar benefits. As a consequence, parties being subject to favourable netting regimes contract with each other much more easily than with parties from jurisdictions that do not easily accommodate netting. Thus, financial market participants that are subject to jurisdictions which offer a consistent legal framework for netting benefit from *competitive advantages* on an individual level.

Reduction of counterparty risk[26]

34. Netting reduces counterparty risk in two ways. First, settlement netting is used to mitigate settlement risk, i.e. to minimise the potential loss resulting from the non-fulfilment by one party of its payment or delivery obligations (*cf. supra*, p. 12).

35. Second, close-out netting counteracts credit risk. The analysis of this functionality takes as its starting point the fact that each contract, whether financial or other, is favourable to one of the parties, i.e. the contract, for that party, results in a positive value (the party is 'in the money'). In the event of insolvency of the other party, this positive amount would probably be lost unless collateralised. By contrast, where a party is 'out of the money', the counterparty's insolvency does not change anything, since it will have to fulfil its obligations vis-à-vis the insolvency estate. Close-out netting agreements address the common situation where there are numerous financial contracts between two parties, some favourable to one party, the others favourable to the other party. Without close-out netting, the solvent party would lose out on all contracts that were favourable to it, but would still have to fulfil those contracts favourable to the insolvency estate.

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[24] *Bank for International Settlements, Monetary and Economic Department*, OTC derivatives market activity in the first half of 2009, November 2009, http://www.bis.org/publ/otc_hy0911.pdf, p. 1.

[25] According to a 2009 paper of the British Bankers' Association its members even benefit from a reduction of exposure by 95-97% on the assumption that enforceable netting agreements are in place: British Bankers' Association, *Special Resolution Regime – BBA Response to HM Treasury Consultation Document*, p. 4.

[26] *Cf.* Angell-Report on Netting Schemes, pp. 6, 9 *et seq.* also referring to increased intra-day liquidity and lower transaction cost.

Capital adequacy and cost of capital

36. Banking supervision has generally recognised the risk-reducing effect of close-out netting. Therefore, banks may calculate capital requirements on the basis of net, rather than gross, credit exposures. However, the theoretical option to use netting in the event of default of the counterparty must be backed by the certainty that a bank can *effectively* limit its exposure to the net amounts. In order to guarantee that capital requirements adequately reflect the exposure of loans and deposits, the Basel II Accord[27] requires banks to:

- have a well-founded legal basis for concluding that the netting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or solvent;
- be able at any time to determine those assets and liabilities with the same counterparty that are subject to the netting agreement;
- monitor and control the risk of sudden increases in exposure when short-dated obligations, which have been netted against longer-dated claims, mature ('roll-off risks'); and
- monitor and control the relevant exposures on a net basis.

37. Only if these conditions are met may banks use the net exposure of loans and deposits as the basis for their capital adequacy calculation in accordance with the relevant formulae. Lower capital requirements immediately result in reduced cost of capital and increased liquidity. Moreover, netting reduces the cost of single financial contracts because less collateral needs to be provided if mutual positions can be netted.

38. However, in order to obtain these advantages there needs to clarity that all courts which are potentially competent would recognise the enforceability of the close-out netting agreement. Banks commission legal opinions to assess the enforceability. In case the relevant law firms cannot provide a legal opinion certifying the enforceability with a sufficient degree of certainty, banks will be unable to calculate their capital basis according to the net exposure. Consequently, banks will need to hold more capital and the cost for it will rise. Enforceable netting arrangements are therefore a factor relative to the competitiveness of individual banks and entire financial market places.

The market perspective: increased systemic stability and liquidity

39. Also from the wider perspective of the financial system, the benefits of enforceability of close-out netting agreements are not confined to crisis situations but likewise materialise under normal market conditions.

Systemic stability

40. Systemic risk occurs where market participants are exposed to each other's failure in such a way that the inability of one financial market participant to meet its obligations when due will cause other participants to fail to meet their obligations when due.[28] The use of close-out netting can prevent this risk of contagion from becoming systemic, i.e. affecting the financial market in such a way that it becomes dysfunctional. This beneficial effect is grounded in the idea that close-out

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[27] *Bank for International Settlements/Basel* Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards (Comprehensive version), June 2006, www.bis.org/publ/bcbs128.htm ('Basel II Accord'), [117.], [118.], [139.], [188.]; Strengthening the resilience of the banking sector, (Consultative Document), December 2009, www.bis.org/publ/bcbs164.pdf?noframes=1, p. 43.

[28] Angell-Report on Netting Schemes, p. 10.

netting shields systemically important market participants from the consequences of their counterparty's insolvency.

41. This is why the Cross-border Bank Resolution Group (CBRG) of the Basel Committee, in its recent report, mentions enforceable netting agreements in a list of mechanisms capable of mitigating systemic risk *in the first place*, along with collateralisation, segregation of client assets and standardisation and regulation of derivatives over-the-counter transactions. Consequently, it calls upon national authorities to promote the convergence of national rules governing the enforceability of netting agreements with respect to their scope of application and legal effects across borders.[29]

Market liquidity

42. Where netting is beneficial on an individual basis, the relevant advantages become manifest also on a global scale. Notably, as capital requirements for financial institutions decrease as soon as an institution applies a consistent netting policy, more capital is available for lending. Further, as collateral provided between counterparties is calculated on the basis of net exposure, fewer assets (cash, securities) are blocked in collateral arrangements. Settlement netting arrangements also decrease transaction costs and consequently render the market more efficient.

43. As a result, it may be assumed that the wide use of netting agreements in the financial market would free funds, which would in turn increase overall market liquidity.

[29] Basel Committee CBRG Report, Recommendation 8, p. 36 *et seq*.

1st Part – Enforceability in the context of general insolvency and commercial law

44. In general, there are no reasons why the law should prohibit or limit the use of netting agreements, which are nothing more than agreements containing the requisite elements to terminate mutual contracts upon the fulfilment of a predefined condition, to value them and to compute their aggregate value. As a consequence, a netting agreement that is freely negotiated and concluded will generally be effective and enforceable as between two solvent parties.

45. The situation is different in the event of *insolvency* of one of the parties, since the primary purpose of insolvency law is to determine the question of which creditor's claims should be prioritised over other creditors' claims. Insolvency law provides for tools like 'cherry picking' and avoidance of contracts in order to put insolvency policies into practice. It is obvious that there is a huge potential for incompatibility between insolvency law and netting, despite the fact that the objective of reducing counterparty and systemic risk becomes dominant *especially* in the event of insolvency of the counterparty.

I. The traditional obstacles to enforceability

46. At present, in many jurisdictions, netting as a legal concept is not fully and clearly recognised. Because of its ready association with existing legal concepts, in particular set-off and the attempt to accommodate netting without legislative change by referring to traditional mechanism like set-off, there may be uncertainty as to the enforceability of netting agreements in accordance with their terms. Some of the typical obstacles to the enforceability of the operation of the netting mechanism are listed below.

Restrictions on set-off applied to netting

47. While it is true that netting has its own functional mechanisms and a wider scope of application than set-off, there are a number of similarities. Further, the concept of netting is new to most legal systems; hence, there is a danger of its being incorporated into national legislation as if it were identical to the concept of set-off (*cf. supra*, p. 12). However, set-off is more limited than netting, and conceptual limitations relevant to set-off that are, in the absence of any clarifying legal rule, applied to netting agreements by judges and insolvency administrators would tend to distort the three functional elements of the netting mechanism:

- set-off applies only to obligations that are due, and not to unperformed obligations: applying this rule to netting would preclude the termination of the financial contracts included in the netting agreement;

- set-off applies only to obligations flowing from the same agreement, or to 'connex' obligations: applying this principle to netting would mean that a netting agreement cannot cover all financial contracts between the parties but only those that are connected;

- set-off applies only to payment obligations or congenerous obligations: the application of this principle to netting would preclude the element of valuation of the financial contracts included in the agreement and their transformation into a single payment obligation.

Cherry picking and prohibition of early termination

48. In an insolvency proceeding, the insolvency administrator often has the right to 'cherry pick' from the insolvent party's non-performed contracts.[30] This means that he is entitled to insist vis-à-

[30] P. Wood, Set-off and netting, derivatives, clearing systems, 2007, section 2-071.

vis any counterparty on performance of those contracts that are favourable to the insolvency estate. In many jurisdictions, the right to 'cherry-pick' supersedes the possibility of terminating open contracts and computing their values so as to form a single net obligation. Where cherry picking applies to the financial contracts covered by a netting agreement, the bundle of financial contracts intended to be covered by the netting mechanism would be disassembled and the solvent party would have to perform all contracts that are unfavourable from its perspective, whereas the favourable contract would not be performed by the insolvency administrator – ultimately, it would be exposed to the full counterparty risk. Those jurisdictions that accommodate netting tend to solve the conflict between cherry-picking and enforceability of netting agreements by disallowing the selection of isolated contracts but giving the insolvency administrator the right to decide whether the net amount is to be paid or not.

Preferences and suspect periods

49. National insolvency laws often contain rules allowing the insolvency administrator or a court to avoid transfers or payments that occurred prior to the opening of the insolvency proceeding, usually on the basis that not to do so would give an unjustified preference to one or more creditors over the remaining creditors, or give rise to unjustified deprivation of the insolvent estate of the relevant assets.[31] In some jurisdictions, only transfers and payments that were made within a legally defined 'suspect period' can be avoided, whilst in other jurisdictions no time limit exists. In the context of netting, the risk is that netting will be equated with performance of the obligations flowing from the financial contract.

50. However, close-out and termination under a netting agreement does not have an effect similar to that targeted by the insolvency avoidance rules. Upon entering the netting agreement, parties are unable to afford a preference to one or the other, as at that time, the provisions are neutral, in that they could apply to whichever party might subsequently become the defaulting party[32] and whichever party might be 'in the money'.

51. As netting agreements often define the termination event as something that might occur chronologically before but close to the opening of insolvency proceeding (for example, the default of one of the parties), the netting mechanism might fall within the scope of the insolvency avoidance rules. Even in cases where the insolvency administrator's attempt to void the transfer or payment is subsequently overruled by a court, the netting agreement would not achieve its purpose of decreasing exposure to counterparties risk and avoiding contagion by the insolvency of one party affecting other participants in the financial market.

Netting agreement void

52. Even in 'netting-friendly' jurisdictions, netting agreements are enforceable only to the extent that they relate to certain types of eligible financial contract. The range of eligible financial contracts differs between jurisdictions, either as a consequence of different policy decisions, or because of difference in the pace of updating the relevant definitions to reflect recent market developments.

Non-eligible contracts included

53. Where non-eligible contracts have been included in the netting agreement, there is uncertainty as to the consequences: since the netting agreement and all the financial contracts it includes are often regarded as *one* contract, general principles of law could block the enforceability

[31] A. McKnight, The Law of International Finance, 2008, section 11.12.2.

[32] A. McKnight, The Law of International Finance, 2008, section 11.12.4.

of the bundle as a whole instead of excluding from the netting mechanism only the specific non-eligible contracts once they had been identified.

Gaming

54. A subcategory of the foregoing relates to financial contracts that might not be enforceable *per se* in certain jurisdictions. This relates mainly to certain derivative contracts that are considered as wagering or gaming contracts.[33] Where the applicable law characterises a type of derivative contract as a non-enforceable gaming contract, the enforceability of the netting agreement with respect to the remaining financial contracts might be endangered.

II. Examples of netting legislation

55. Approximately 40 jurisdictions have adopted close-out netting legislation.[34] These jurisdictions have striven for a principled and reliable legal framework with a view to rendering netting agreements enforceable. However, rules differ considerably between jurisdictions as to material scope, personal scope, legal approach and a number of issues relating to formal and similar requirements.

56. In the following section the basic features of netting frameworks in force in a number of jurisdictions are described. These jurisdictions were chosen having regard to the originality of their approach, their geographic role, the importance of their market and the accessibility of information. It should be noted that is the descriptions are necessarily fragmentary, *cf.* the foreword, which also means that the contractual relationships may in many cases be considerably more complicated.

Belgium

57. Belgian law captures the concept of netting by combining the traditional notion of set-off with a functional description of the various steps comprised by netting.

58. 'Netting agreements as well as termination clauses, conditions subsequent or acceleration clauses stipulated in order to allow novation or set-off, may, without any prior notice or default of judicial decision, notwithstanding any transfer of rights thereunder, in the case of an insolvency proceeding, attachment or any situation where the *pari passu* principle applies, be enforced upon creditors provided the claims and debt be novated or set-off existed at the time of opening of the insolvency proceeding, the attachment or situation where the *pari passu* principle applies, irrespective of their maturity date, subject-matter or the currency in which they are denominated.' [35]

Brazil[36]

59. Under Brazilian law there is no distinction between the definitions of set-off and netting, the applicable legislation refers simply to *compensação*.

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[33] P. Wood, Set-off and netting, derivatives, clearing systems, 2007, section 13-009.

[34] ISDA regularly updates a list of countries that have adopted netting legislation on its website www.isda.org>opinion and legislation>Netting legislation status: Andorra; Anguilla; Australia; Austria; Belgium; Brazil; British Virgin Islands; Canada; Colombia; Czech Republic; Denmark; Finland; France; Germany; Greece; Hungary; Ireland; Israel; Italy; Japan; Luxembourg; Malta; Mauritius; Mexico; New Zealand; Norway; Peru; Poland; Portugal; Romania; Russia; Slovakia; Slovenia; South Africa; South Korea; Spain; Sweden; Switzerland; United Kingdom; and United States. Netting legislation is currently under consideration in Argentina; Chile; Pakistan; and Seychelles.

[35] Article 3 paragraph 4 and Article 14 Financial Collateral Act 15 December 2004.

[36] I am grateful to Natalia Camargo Barros and Danilo Takasaki Carvalho, both LLM Students at LSE, for their help with identifying and translating the relevant Brazilian provisions.

Generally, there are three distinct regimes:

60. The general bankruptcy law recognises netting only to a certain extent. Cherry picking by the insolvency administrator does exist[37] but is limited by the general enforcement of early termination clauses.[38] Consequently parties may provide for the acceleration of the debt and operate netting if one of the parties becomes insolvent. Additionally, the law itself stipulates early termination of all of the bankrupt's debts upon declaration of its insolvency which to some extent could protect netting.[39] Consequently, in principle, the administrator should be prevented from being able to avoid the operation of the netting agreement but there seems to be uncertainty regarding whether the administrator might be able to challenge the termination of contracts as allowed under the netting agreement.

61. A separate legal regime covers regulated financial institutions: Set-off and liquidation agreements covering transactions concluded between such institutions can be enforced in accordance with their terms (subject to formal requirements).[40] Equally, netting agreements entered into between a party that is not a licensed financial institution and such an institution are protected.[41]

62. Lastly, there is a specific rule protecting close-out netting of transactions cleared through a clearing organisation: in case of any of the clearing house members becomes insolvent, its participants' agreements are honoured in accordance with their terms and with the clearing house's rules and regulations.[42]

England & Wales

63. In England and Wales, close-out netting in connection with financial collateral is defined[43] as a term of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or any legislative provision under which on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise (a)the obligations of the parties are accelerated to become immediately due and expressed as an obligation to pay an amount representing the original obligation's estimated current value or replacement cost, or are terminated and replaced by an obligation to pay such an amount; or (b) an account is taken of what is due from each party to the other in respect of such obligations and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other part.

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[37] Article 117 Bankruptcy Law L11-101 or 9 February 2005.

[38] Article 333 Brazilian Civil Code.

[39] Article 77 Bankruptcy Law: Art. 77. 'The declaration of insolvency determines the acceleration of all of the debtor's and its joint and several partners debts, with the proportional reduction of interest. Additionally, all credits in foreign currencies will be converted to National currency, pursuant to the exchange rate of the date of the judicial decision, for all effects as described in this Law'.

[40] Article 30 paragraphs 1, 2 Provisional Measure No. 2.192-70/2001' Netting and liquidation agreements that occur within the National Financial System are hereby authorized pursuant to the rules and circumstances determined by the National Monetary Council'; Resolution No. 3.263/2005, of the National Monetary Council.

[41] Art. 119, VIII Bankruptcy Law.

[42] 'The civil insolvency, bankruptcy, reorganisation, intervention or extrajudicial liquidation, to which any of the clearing house's participants is subject to, shall not affect its outstanding agreements that have been entered into with the clearing house or with compensation and liquidation services providers. Such outstanding obligations shall be liquidated by the clearing house or the compensation and liquidation services provider pursuant to its rulings and regulation'.

[43] Section 3 Financial Collateral Arrangements (no. 2) Regulations 2003; http://www.legislation.gov.uk/uksi/2003/3226/contents/made.

64. Such agreements or legislative provisions shall take effect in accordance with their terms notwithstanding the opening of an insolvency proceeding in respect of one of the parties.[44]

65. Outside the scope of the financial collateral regulation, English law[45] does not define netting but relies on a broadly defined mechanism of insolvency set-off: '[...] where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company [...] an account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other'.

66. A sum shall also be regarded as being due if it is future or contingent. Only the balance (if any) of the account owed to the creditor is provable in the liquidation. Alternatively the balance (if any) owed to the company shall be paid to the liquidator.

EU (conflict-of-laws approach)

67. Under EU law, there are two different approaches protecting netting. First, there is the earlier approach which might be regarded as 'conflict-of-laws approach'. It is followed by the EU Banks' Winding-Up Directive[46] which prescribes that 'netting agreements shall be governed solely by the law of the contract which governs such agreements'. [47]

68. The understanding of the ambit of this protection is complicated as the Directive also prescribes[48] that the law of the state of the opening of the insolvency proceeding may determine, amongst other things, the conditions under which 'set-off' (!) may be invoked. Further, the opening of a winding-up proceeding shall not affect the right of creditors to demand the set-off of their claims against the claim of the debtor, where such a claim is permitted by the law applicable to the insolvent debtor's claim. However, this shall not preclude actions of voidness, voidability or unenforceability applicable under the law of the state of the opening of the proceeding. [49]

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[44] Section 12 paragraphs 1, 2 Financial Collateral Arranements (No. 2) Regulations 2003.

[45] Rule 4.90 paragraphs 1, 3, 4 and 8 Insolvency Rules 1986; http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/legislation/uk/insolvencyrules.pdf.

[46] Article 25 Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions.

[47] A. Caillemer du Ferrage, Close-out netting & faillites internationals, R de Droit bancaire et financier, 1 (2007), [12.] et seq. Detailed analysis in European Financial Markets Lawyers Group, Protection of bilateral insolvency set-off and netting agreements under EC law, October 2004, No's 112-125.

[48] Articles 10 paragraph 2(c) and 23.

[49] There is an additional, directly applicable regime for non-financial firms, the EU Insolvency Regulation 1346/2000 of 29 May 2000, Articles 4 paragraph 2(d) and 6. These rules correspond literally to Articles 10 paragraph 2(c) and 23 of the Bank Winding-up Directive. However, it does not comprise a rule on netting corresponding to the substance of Article 25 Banks Winding-up Directice. Consequently, the Insolvency Regulation probably only applies to set-off. The legal situation is unclear, European Financial Martkets Lawyers Group, ibid., in particular No's 99-106; U. Jahn, Kapitalmarkt, Wertpapier-, Effekten- und Investmentgeschäft, in Schimansky/Bunte/Lwowski, Bankrechtshandbuch Vol. II (2007), §114 [137.]. Cf. on the ambit of Articles 4 paragraph 2 and 6 Insolvency Regulation, which corresponds to Article 23 Bank's Winding-up Directive: F. Melin, La loi applicable à la compensation dans les procédures communautaires d'insolvabilité, (2007) 2 Journal du Droit International, [27.] ; A. Caillemer du Ferrage, Close-out netting & faillites internationals, R de Droit bancaire et financier, 1 (2007), [6.] et seq.

EU (substantive law approach)

69. The EU Financial Collateral Directive[50] is the most recent measure and follows a 'substantive law' approach, according to which 'Member States shall ensure that a close-out netting provision can take effect in accordance with its terms: (a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or (b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of such rights.'

70. Additionally, the operation of a close-out netting provision may not be subject to formal requirements such as prior notice, court approval, etc., unless otherwise agreed by the parties. However, the Financial Collateral Directive does not contain the requirement of good faith that is included in its English implementation measure.

71. A close-out netting provision is defined as a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise: (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

France

72. French law also uses a combination of both reference to set-off and functional description: Financial contracts entered into by financial institutions can be terminated ('*sont résiliables*') and the resulting rights and obligations can be set off ('*sont compensables*') and the parties can determine a single amount ('*solde unique*').[51]

73. Further, the law states that the termination, valuation and set off ('*compensation*') of the eligible transactions and obligations are effective against third parties and that these actions may occur under the provisions of a master agreement.[52]

Germany

74. In simple terms, the relevant provision of German law[53] applies the following mechanism: by mandatory operation of law[54], all unperformed or partly unperformed financial contracts are terminated upon insolvency of one of the parties and transformed into a claim corresponding to the replacement value at market price. Cherry picking by the insolvency administrator is avoided

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[50] Article 7 Financial Collateral Directive (2002/47/EC). The EU Settlement Finality Directive (98/26/EC) also provides for a rule on netting, following which 'netting shall be legally enforceable and binding on third parties even in the event of insolvency proceedings against a participant', Article 3 paragraph 1. However, this rule is aimed at protecting settlement netting (as opposed to close-out netting, cf. pp. 14 et seq.) as can be seen from the definition: 'netting shall mean the conversion into one net claim or one net obligation of claims and obligations resulting from transfer orders which a participant or participants either issue to, or receive from, one or more other participants with the result that only a net claim can be demanded or a net obligation be owed', Article 2(k) Settlement Finality Directive.

[51] Article L211-36-1 paragraph 1 Code monétaire et financier.

[52] L.211-36-1 paragraph II Code Monétaire et Financier.

[53] § 104 paragraphs 1, 3 Insolvenzordung.

[54] U. Jahn, Kapitalmarkt, Wertpapier-, Effekten- und Investmentgeschäft, in Schimansky/Bunte/Lwowski, Bankrechtshandbuch Vol. II (2007), §114 [141.].

because the bundling of financial contracts under a master agreement[55]. The master agreement and the financial contracts covered by it are regarded by the law as one single financial contract, resulting in one single claim, which is to be paid by or to the estate.

Japan

75. Under Japanese law[56], netting occurs as the consequence of mandatory provisions of law: each financial contract which forms part of a master agreement is required to be valued in accordance with specific legislation, upon occurrence of a termination event. The aggregate net balance of all contracts under the master agreement become a single claim or obligation between the parties.

Russia

76. The new Russian law[57] takes a functional approach and describes netting as an agreement providing for the termination of transactions upon the occurrence of a termination event and calculation and payment of the net amount.[58]

77. The statutory prohibition of set-off does not apply to the calculation of the net amount occurring under a master agreement (provided that the latter complies with a number of formal requirements).[59] Further, on the basis of the new law, cherry-picking by the insolvency administrator is explicitly excluded by a provision limiting his right to refuse performance of single contracts and obliging him to refuse either performance of all of the contracts, or none of them.[60] Claims against the insolvent for payment of the net amount rank *pari passu* with claims of other unsecured creditors.[61]

South Africa

78. The law of South Africa takes an approach of statutory insolvency netting, following which all unperformed obligations arising out of one or more master agreements between the parties shall, upon opening of an insolvency proceeding of a party to such agreement terminate automatically on the date of the opening of the proceeding. The values of those obligations must be calculated at market value as at that date, the values so calculated must be netted and the net amount is be payable.[62]

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[55] Whereas a master-master agreement would not be recognised, U. Jahn, ibid.

[56] Article 2 paragraph 6 Law concerning Close-out Netting of Specified Financial Transactions entered into by Financial Institutions, etc.

[57] For a complete English-language overview of new Russian legislation (on which this section is based): T. Amara, A. Anichkin, Netting in Russia, Clifford Chance client briefing January 2011.

[58] Section 51.5.1 (new) Securities Market Law, as amended by the Law introducing amendments to various legal acts of the Russian Federation following the adoption of the Federal Law on Clearing, of 7 February 2011, No. 8-FL. I am grateful to Alexandra Plisakova, LLM Student at LSE, for her help with identifying and understanding the relevant Russian provisions.

[59] Section 63.1 Insolvency/Bankruptcy Law, as amended by the Law introducing amendments to various legal acts of the Russian Federation following the adoption of the Federal Law on Clearing, of 7 February 2011, No. 8-FL.

[60] Ibid. Section 102.6.

[61] Ibid. Section 137.5.

[62] Section 35B. paragraph 1 Insolvency Act (24 of 1936), www.justice.gov.za/legislation/acts/acts_full.html.

South Korea

79. South Korean law takes the approach of guaranteeing the enforceability of the netting agreement as contained in a master agreement. The rule[63] provides that the termination and calculation of settlement amounts of eligible financial contracts shall, notwithstanding any provision of the insolvency law, take effect in accordance with the parties' agreement in the master agreement and shall not be subject to rescission, termination, revocation or avoidance.

United States

80. US corporate and bank insolvency laws[64] generally ensure the enforceability of a closeout netting agreement by allowing a non-defaulting party to exercise its rights (under contract or otherwise) to cause the termination, liquidation, acceleration and netting of termination values arising under one or more master netting agreements. These rights may generally not be stayed, avoided, or otherwise restricted except in cases of actual fraud.

III. The 5 areas of discrepancy

81. The above presentation of the basic approach to netting in eleven 'netting friendly' jurisdictions gives an impression as to the different national law approaches to addressing netting. Five areas can be defined in which jurisdictions provide for differing solutions in respect of the enforceability of netting

What constitutes netting

82. The first issue is the understanding (or the definition) of 'netting'. At the beginning of this paper netting was defined as consisting of four functional elements: termination, acceleration, valuation, and computation of a net amount. Jurisdictions translate these concepts into their law very differently.

Netting close to set-off

83. It is obvious that the definition of netting is intimately linked to the question of whether set-off and netting are comparable and the terminology interchangeable. In many cases, legislation seems to rely on blending the traditional notion of set off with the additional elements of termination and acceleration of the covered financial contract. This might cause uncertainty as to whether restrictions that applied traditionally to set-off also should apply to netting.

84. A specific problem is the case in which it is not clear whether there is any substantive netting rule *at all,* or just set-off. For example, the approach taken under the EU Bank's Winding up Directive[65] includes an attempt to guarantee the enforceability of netting in cross-jurisdictional situations ('netting agreements shall be governed solely by the law of the contract which governs such agreements'), but at the same time there no indication as to what the legal framework for netting would be at the domestic level. The Directive provides substantive rules exclusively in respect of set-off, raising doubts as to whether the four functionalities of netting would be covered and whether traditional national limits imposed on set off would also apply to netting.

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[63] Article 120, Paragraph 3 of the Debtor Rehabilitation and Bankruptcy Law, cited after a translation by J. Park and S-K Hong, Special Treatment of Derivatives in Korean Insolvency Proceedings: Comparison with the United States and Japan, (2008) 7 Korean L. 357, in footnote 29.

[64] Cf. inter alia Title 11 (Bankruptcy) section 561(a) United States Code.

[65] Cf. supra, p. 28, including reference to the analysis of the European Financial Markets Lawyers Group.

Does the law need a precise definition of netting?

85. There is an issue whether effective protection of the enforceability of netting requires a detailed functional definition of netting. Some jurisdictions build netting legislation on a very precise description of what constitutes netting, others do not. Some jurisdictions seem to partly or fully refer the definition of netting to the relevant master agreement. Another issue is whether a definition of netting is needed at all if the legal consequences of netting are provided for in the statute itself.

The legal mechanism protecting enforceability

86. The second area where netting laws differ relates to the mechanism by which domestic law ensures the enforceability of what is understood as 'netting'.

Comprehensive or non-comprehensive approach?

87. Some jurisdictions shield enforceability of netting rules against interference from *any* law, i.e. insolvency law and other general rules, and *any* judicial act by providing that a netting agreement shall take effect in accordance with its terms

88. Under the more limited non-comprehensive approach, the law shields the enforceability of netting agreements only against *certain* rules or judicial acts (for example: 'The enforceability of netting agreements shall not be affected by any rule of insolvency law'). An important aspect of this approach is that it normally shields close-out netting agreements from the most obvious causes of unenforceability, in particular the avoidance and cherry-picking tools of insolvency law. However, it may be unclear to what extent enforceability could be challenged on other grounds, for example limits imposed on set-off or general provisions of law entailing voidance, *cf. supra* pp. 20 *et seq*.

Enforceability of netting agreement vs. 'statutory insolvency netting'

89. Some netting legislation recognises the close-out netting *agreement* concluded between the parties and guarantees its enforceability. Other jurisdictions take a different approach by providing for termination, valuation and calculation of the net amount *to occur by operation of the law itself*. This latter approach is familiar from statutory insolvency set-off but goes further than set-off, which is why is can be more precisely described as 'statutory insolvency netting'.

90. Two questions flow from consideration of these different approaches.

91. First, whether both approaches provide for a similar result in functional terms: can the same result as intended by the parties – to operate a netting agreement at the occurrence of a termination event – also be achieved by statutory insolvency netting?

92. Second, it is unclear whether all approaches are coherent.

- In respect of the approach of recognising the enforceability of netting agreements, there might be potential for conflict between the principle of party autonomy and public policy considerations.

- In relation to the 'statutory insolvency netting' approach, there is a question as to what extent the mechanisms provided for in the law should be able to interfere with a contractual netting agreement, notably by being narrower. For example, in the UK, contractual netting is accepted only as long as it does not give rights better than those granted under statutory insolvency set-off.[66]

Formal requirements in respect of the agreement

93. Many jurisdictions attach a number of formal requirements to the enforceability of netting agreements in case of insolvency of one of the parties. These formal requirements include:

- The netting agreement requires registration or a similar act with a pre-determined public, private or self regulatory entity.
- The financial contracts or the collateral covered by the netting agreement require registration.
- The netting agreement must be governed by domestic law.
- The netting agreement must be part of a master agreement and cannot be customised.
    - The master agreement must follow a model approved by an authority or self-regulatory body, allowing for no or only certain customised clauses to be included.
    - The master agreement must be based on a model that has been endorsed by a recognised trade association.
    - The master agreement must be a 'domestic' one, i.e. promoted by a domestic trade association, in the domestic language, etc.
- The operation of the netting agreement needs to be notified to a court or other authority.
- The operation of the netting agreement needs to be authorised by a court or other authority.

94. Formal requirements are not referenced in the eleven examples of national netting rules presented earlier. However, the differences between the requirements in the different jurisdictions are enormous: some jurisdictions require compliance with specific formalities, others don't.[67] Where compliance with formalities is required, the formalities differ. Often, the requirements are inextricably linked with the national regulatory architecture (i.e., registration with one specific, national register). Failure to comply with the formal requirements usually entails unenforceability of the netting agreement.

Eligible contracts covered by the agreement

95. There are different approaches to the eligibility of financial contracts to be covered by an enforceable netting agreement. Defining eligibility is one of the methods used to to restrict the scope of netting in order to limit its benefits to those institutions for which the availability of netting is considered important for systemic reasons.

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[66] J. Dalhuisen, Transnational comparative, commercial, financial and trade law, Vol. 3, 4th ed. 2010, p. 341 in fn. 408; A. McKnight, The Law of International Finance, 2008, section 14.11.2.3.2.; L.C. Ho, The Financial Collateral Directive's practice in England, J of International Banking Law and Regulation (2011), p. 167 et seq.

[67] The EU has decided to abolish formal requirements in respect of netting agreements which are entered into in connection with a collateral arrangement, Articles 2 paragraph 1(n) and 3 Financial Collateral Directive.

96. Generally,

- derivates, and
- sale, repurchase or lending agreements relating to securities or commodities

are regarded as eligible contracts. Some jurisdictions also allow for the following to be included:

- Security interests, including non-title transfer collateral agreements and also title-transfer-collateral agreements
- Agreements regarding the maintenance of financial instruments in accounts (intermediated securities)
- Agreements regarding the safekeeping of physical securities.

97. There is a great deal of difference in the detail. Market associations try to maintain authoritative comparative overviews covering about 20 different types of these contracts. However, diversity stems also from the fact that there is not a common nomenclature that would allow for an easy comparison of what can be covered by netting agreements under a certain law and what cannot.

Eligible parties

98. Most netting-friendly jurisdictions limit enforceability to certain categories of eligible party. This is another method by which jurisdictions may restrict the scope of netting legislation for policy considerations. Banks are eligible parties in all jurisdictions. Other categories of participant that are eligible parties in at least some jurisdictions are: insurance companies, investment firms, partnerships, investment funds, hedge funds, proprietary traders, pension funds, central banks, public authorities, international financial institutions, etc.

99. Natural persons, by contrast, are only eligible under very limited circumstances. The issue of whether they should be included is often discussed against the background of consumer protection. However, certain types of financial businesses can also be organised as a natural person or a collective of natural persons. Good examples are the different species of 'partnerships' in the various jurisdictions, for example engaging in an investment fund activity or a traditional trading business.

100. The following grid illustrates the breadth of diversity of approaches in the different jurisdictions. Again, this is a heavily simplified overview. It leaves out natural persons since sensible simplification appeared to be impossible.

Table: eligible parties in select jurisdictions

	Banks	Investment firms	Insurance companies	Funds	Public entities	Central Banks	Clearing houses	Internat. financial organisation	Other Corporations	Foreigners
Belgium	covered	covered	covered	covered	covered	covered	covered	covered	covered	covered
Brazil	covered	Covered if contract with certain counterparty	Covered if contract with certain counterparty	Covered if contract with certain counterparty	Covered if contract with certain counterparty	covered	covered	Covered if contract with certain counterparty	Covered if contract with certain counterparty	Covered if contract with certain counterparty
England and Wales	covered	covered	covered	covered	covered	covered	covered	covered	covered	covered
France	covered	covered	covered	Covered if contract with certain counterparty	covered	No clear information	covered	covered	Covered if contract with certain counterparty	covered
Germany	covered	covered	covered	covered	covered	covered	covered	covered	covered	covered
India	covered	No clear information	covered	No clear information	No clear information	covered	No clear information	No clear information	covered	covered
Japan	covered	covered	covered	No clear information	No clear information	No clear information	No clear information	No clear information	Covered if contract with certain counterparty	covered
Russia	covered	covered	No clear information	Covered if contract with certain counterparty	Covered if contract with certain counterparty	covered	No clear information	covered	Covered if contract with certain counterparty	covered
South-Africa	covered	covered	covered	No clear information	No clear information	No clear information	No clear information	No clear information	covered	covered
Rep. of Korea	covered	covered	covered	covered	covered	covered	covered	covered	covered	unclear
USA	covered	covered	Covered if contract with certain counterparty	Covered if contract with certain counterparty	Covered if contract with certain counterparty	covered	covered	Covered if contract with certain counterparty	Covered if contract with certain counterparty	covered

No clear information — covered — Covered if contract with certain counterparty — unclear

Notes on the table

Brazil: The application of the rule extending eligibility to *foreign* counterparties is limited to financial transactions entered into with licensed Brazilian financial institutions. Other legal entities and natural persons may not set-off their mutual obligations with *foreign* counterparties due to a longstanding foreign exchange statute. There is academic opinion that this does not affect the validity of early-termination or netting clauses in foreign transactions, subject to the proviso that for their validity, such clauses can only rely on general civil and insolvency law principles. The legislation for clearing houses protects both national and foreign transactions.

France: When the financial obligations result from transactions on financial instruments, at least one party to the transaction must be a Qualifying Entity in Article L211-36 French Monetary and Financial Code. When the financial obligations result from any agreement giving a right to a cash settlement and/or delivery of financial instruments, all the parties must be a Qualifying Entity in Article L211-36 French Monetary and Financial Code.

Germany: The close-out netting provisions are included in the general insolvency code. The question whether entities are covered by this general code (e.g., local authorities) and enjoy close-out netting protection would need to be determined by the facts in each individual case.

Japan: For the netting legislation to apply to non-financial corporations, at least one party must be a qualifying entity.

Russia: The new law provides that the Russian Federation, regions and municipalities, and foreign states, regions and municipalities and other Russian or non-Russian entities are within the scope of the Russian close-out netting legislation provided one of the parties is a financial institution.

South-Africa: Close-out netting provisions are applicable to those counterparties that are subject to the Companies Act or to statutory entities whose statutes specifically include the application of the Insolvency Act. Not expressly included are the Central Bank, International Organisations, local authorities, sovereigns, sovereign wealth funds, sovereign owned entities and foreign states.

Republic of Korea: If the material conditions are satisfied, the protection of the enforceability of netting can be enjoyed by any type of party even in case of insolvency of the counterparty.[68] There is some uncertainty as to the eligibility of a Korean branch of a foreign bank due to statutory preferential treatment of Korean citizens and resident foreigners.

United States: financial market participants such as insurance companies, municipalities, pension plans and other entities subject to US state law insolvency proceedings are not subject to close-out netting protection as is granted to US Bankruptcy Code-eligible entities and US financial institutions.

IV. Cross-border compatibility?

101. The description in the previous sections does not include any information on how the relevant domestic substantive rules on netting and insolvency would apply in a cross-jurisdictional case. Indeed, today's financial market is increasingly international and it is increasingly less likely that relevant commodities, re-purchase, securities-lending and derivative contracts will be strictly confined within the borders of just one jurisdiction. In many instances, cross-jurisdictional elements will be present. Whether the law on netting and insolvency in a given case will deliver a predictable result depends, in part:

- on the clarity and compatibility of each jurisdiction's conflict-of-laws rules (*cf.* section 1., *infra*), and,
- on a high level (ideally complete) consistency among the substantive law rules (*cf.* section 2, *infra)*.

1. Conflict-of-laws

102. The following outline of conflict-of-laws rules does not relate to any specific jurisdiction and is limited to general principles.[69]

103. In relation to some of the issues relevant to cross-jurisdictional netting, the conflict-of-laws rules seem to be clear and relatively settled. In relation to other issues, there seems to be doubts regarding the existence of a generally accepted conflict-of-laws principle. In view of this uncertainty, the statement of what 'might' be the conclusion does not necessarily mean that this would be the conclusion in all jurisdictions.

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[68] J. Park and S-K Hong, *Special Treatment of Derivatives in Korean Insolvency Proceedings* (2008) 7 Korean L., p. 357.

[69] Cf. for guidance: A. Caillemer du Ferrage, Close-out netting & faillites internationals, R de Droit bancaire et financier, 1 (2007), Section 2; U. Jahn, Kapitalmarkt, Wertpapier-, Effekten- und Investmentgeschäft, in Schimansky/Bunte/Lwowski, Bankrechtshandbuch Vol. II (2007), §114 [136.]-[137a.]; A. McKnight, The Law of International Finance, 2008, sections 4.5.8, 4.5.8.15, 5.4, 5.5, 14.11.2.3.3; P. Wood, Set-off and netting, derivatives, clearing systems, 2007, section 6-013 et seqq.

Law applicable to the insolvency proceeding (lex concursus)

104. If one of the parties to a netting agreement becomes insolvent, the following rules determine the applicable insolvency law.

- The law of the forum, i.e. the jurisdiction which opens the insolvency proceeding over the relevant party, will be the applicable law (*lex concursus*).
- If the insolvent party has one or more branches in foreign jurisdictions, there are various scenarios.
  - Where the principle of universality is applied, the party and its branches are subject to a common proceeding under the *lex concursus.*
  - Where the territoriality principle applies, different insolvency proceedings will be opened under different laws in different jurisdictions.
  - Even if the jurisdiction of the headquarters applies the universality principle, it cannot prevent a foreign jurisdiction from taking a territorial approach in respect of the insolvency of a branch in that foreign jurisdiction.

Law applicable to the netting agreement (lex contractus)

105. A netting agreement, whether a stand-alone contract or as part of a master agreement, is a private contract and therefore subject to party autonomy. That is, the parties can choose the law applicable to the contract[70]. It is quasi standard international practice for the parties to choose either English law or New York law.

- The applicable law will govern the issues of validity and enforceability of the netting agreement.
- The choice of law in principle 'survives' the opening of an insolvency proceeding in respect of one of the parties. Thus, the insolvency court will in principle uphold the validity and enforceability of the netting agreement in accordance with the foreign law.
- However, mandatory rules of the *lex concursus* might supersede the netting agreement to the extent there is a conflict with the effect that the *lex concusus* would apply to these aspects. The result may be that clauses of the netting agreement which the parties intended would override general law are themselves overridden. This issue is relevant in relation to, in particular:
  - avoidance for preferences;
  - violation of the *pari-passu* principle in favour of all general creditors of the insolvent;
  - violation of the principle that the parties cannot agree that upon insolvency assets are moved out of the estate (anti-deprivation principle); and,

[70] There is the general caveat that most jurisdictions prohibit an 'abusive choice', i.e. a choice aiming at the circumvention of otherwise applicable domestic law. There is also a more specific caveat to the freedom to choose the law of a netting agreement, notably in jurisdictions requiring master agreements being concluded on a binding domestic model contract which would regularly stipulate domestic law being the applicable law. An additional exception might flow from consumer protection law limiting the freedom of choice of law if one party is a consumer, as for example Article 6 paragraph 4(d) EU Regulation 593/2008 on the law applicable to contractual obligations ('Rome I').

- the possibility of terminating the netting agreement, in particular where the *lex concursus* imposes a moratorium on termination.

The law applicable to the contracts and assets covered by the netting agreement (lex contractus or lex situs/Prima)

106. The various positions covered by the netting agreement are also subject to party autonomy as regards the choice of law, to the extent that they are contractual positions. In most cases, parties will choose the same law for both the netting agreement itself and the financial contracts covered by it. However, this is not an absolute rule.

- For a variety of reasons some of the financial contracts covered by a netting agreement could be governed by a law different from the law governing the netting agreement.

- To the extent that the netting agreement covers title-transfer or non-title transfer collateral provided over securities or other financial instruments booked to an account, proprietary issues relating to the transfer, realisation or return of the collateral will be governed, following the conflict-of-laws rule of the *forum*, by the law which is identified by some form of the 'place of the relevant intermediary' or 'Prima' principle.[71] If the relevant account is located in a foreign jurisdiction the law of that jurisdiction will govern the proprietary aspects.

- Standard documentation often provides that the netting agreement together with the covered financial contracts forms one single contract. Statutory insolvency netting rules sometimes provides for the same result, i.e. that contracts and the netting agreement are to be regarded as one single contract. Where some of the covered contracts or assets are governed by a different law, the following might apply.

  - If the netting agreement is subsequently put 'on top' of a bundle of financial positions, some of which are governed by a foreign law,

    - A court might hold that the choice of law made in the netting agreement altered all previous differing choice-of-law clauses contained in *contracts* (either generally or as regards any issue relating to the meaning and effect of the netting), and would be likely to do so if the netting agreement expressly provided that its choice of law was to override any inconsistent choice of law in the financial contracts covered.

    - As regards proprietary aspects arising in relation to securities collateral an alteration of the governing law is not possible. However, a court might agree that this inability to alter the governing law concerns only the core proprietary question and that for non-proprietary questions of the collateral arrangement (for example the duty to retransfer equivalent collateral) [72] the applicable law could be changed by the subsequently concluded netting

[71] The basic rule is that the law of the account applies to the securities, instead of the law under which the securities are issued or the law of the place where the paper securities are located or the law of the place where the initial electronic record is made. There are two sub-species of Prima: either the law of the account is the law agreed upon by the parties or the law of the account is the law of the place where the account is maintained.

[72] In relation to a repurchase agreement, for example, the question of whether title to the purchased securities has been effectively transferred on the purchase leg of the transaction is one of property law, which will be governed by the law applicable to proprietary issues (and which will not necessarily be the same as the contractual governing law); but unless and until equivalent securities are actually transferred from buyer to seller on the repurchase leg of the transaction, the obligation to transfer equivalent securities is an outstanding contractual obligation which will be governed by the contractual governing law.

agreement. This latter scenario would result in a case of hybrid governing law.

- If the netting agreement including a particular choice of law clause has been entered into, and subsequently the parties enter into financial transactions of the kind covered by that agreement, but under a contract which includes an express choice of a *different* law, it is difficult to argue that the law governing the netting agreement impliedly prevails over this choice. A court might hold that for all purposes relevant for the operation of the netting agreement the law of the netting agreement should apply. All other aspects of these financial contracts, in particular pertaining to their content, would be determined according to the law chosen by the parties to these contracts.. This would result in hybrid governing law. The assessment regarding foreign law governed securities collateral (*supra*) applies *mutatis mutandis*.

2. Failure to properly connect the substantive law

107. The first step in achieving a legally certain cross-jurisdictional situation is building clear conflict-of-laws regimes which are also compatible across jurisdictions. One reason for this is that an unclear conflict-of-laws framework multiplies the effects of incompatible substantive law:

Complicated/unclear conflict-of-laws rules *

- Differing understanding of 'netting'
- Differing mechanism to protect enforceability
- Differing formal requirements
- Differing set of eligible financial contracts
- Differing set of eligible parties

108. Whether, in addition to clarifying conflict-of-laws rules, alignment of the substantive law is needed as a second step depends on the question of whether the substantive law delivers, in a cross-jurisdictional context (and setting aside potential conflict-of-laws problems), clear and predictable results that properly balance the public interest and the justified expectation of the parties.[73] If it does not, there is legal uncertainty even on the side of substantive law.

Incompatible understanding of 'netting'

109. The first example relates to the question of how jurisdictions translate the concept of netting into legal concepts. The country-examples presented earlier showed a great variety of approaches.

Example 5 *: Both Jurisdictions A and B are considered 'netting friendly'. The parties conclude a netting agreement governed by the law of Jurisdiction A, which, in accordance with that law, stipulates in its language the equivalent of 'cancellation, acceleration and set-off' of all mutual rights and obligations. The party in Country B becomes insolvent. The insolvency law of Jurisdiction B has a netting rule which stipulates that netting shall be enforceable in accordance with the terms of the agreement. Further, there are rules regarding the enforceability of set-off in the insolvency, prescribing that set-off is not possible in case the law applicable to the debtor's claim prevents it and that the question of avoidance for preferences is governed by the applicable insolvency law. Additionally, set-off requires that the mutual*

[73] N.b. that negative consequences of unexpected decisions are not confined to the parties. There is a significant potential for knock-on effects if the expectations of an entire industry are frustrated in respect of widely used standard market documentation.

obligations are of the same kind. The court in Jurisdiction B does not apply the netting but the set-off rule and considers the calculation of a net amount impossible by virtue of one or the other of the requirements for set-off.

110. This example shows how conceptually different approaches translate into legal uncertainty. The netting agreement should be upheld, in principle, in both jurisdictions. However, despite the fact that 'netting' is the intention of the parties the wording leads to application of the rules on set-off in the second jurisdiction. The use of the term set-off is the most obvious example of how easily definitional differences provoke misunderstandings in respect of concepts, in particular because set-off is a separate legal concept that does and will continue to exist in probably most jurisdictions, in one or the other form.

Incompatible mechanism protecting enforceability

111. The second example equally relates to the core characteristics of netting legislation, as presented in the country overview.

Example 6 *: Jurisdictions A and B are both considered 'netting friendly'. The parties conclude a netting agreement governed by the law of Jurisdiction A. The statutory framework under Law A provides that a netting agreement is enforceable in accordance with its terms' and leaves all details of the netting mechanism to the parties' agreement. Two parties conclude a netting agreement with a very wide understanding as regards the list financial instruments covered. Additionally, they stipulate a specific valuation mechanism. The law in Jurisdiction B has a netting rule of the 'statutory insolvency netting' type, i.e. upon insolvency of one of the parties the contracts are terminated, valued and the net amount calculated by mandatory operation of law. The party located in Jurisdiction B falls insolvent. The list of netting-eligible contracts under the law in Jurisdiction B does not cover all transactions included in the netting agreement. The valuation mechanism under the law in Jurisdiction B settles on market value of the terminated contracts and is different from the valuation mechanism included in the netting agreement. The Court is of the opinion that the statutory insolvency netting applies. Further, it holds that the statutory list of eligible contracts and the valuation mechanism as set out in the law in Jurisdiction B have to be applied, instead of applying the criteria under the law in Jurisdiction A, i.e. the netting agreement is disregarded despite the agreement of the parties. Some of the covered contracts are considered being not 'nettable'. The remainder is netted using the statutory valuation method instead of the stipulated one.*

112. In this example, the netting agreement is disregarded, which does not of itself rule out whether netting will occur. However, the parties' agreement on which the various covered financial contracts were built from the outset is disregarded. The parties would have concluded different contracts had they known that their valuation mechanism would not be used.

Incompatible lists of eligible contracts, parties, and formalities; merger

113. The remaining three areas of discrepancy between national netting-friendly legislation (eligible contracts, eligible parties, formalities) appear to be somewhat different from the issues dealt with in the previous sections. Often, the question of whether parties or contracts are eligible for netting is not clearly answered by the law is a particular jurisdiction. This is a problem of internal legal soundness, not one of cross-jurisdictional incompatibility. Therefore, the clarification of national rules and the fostering of cross-market understanding regarding these important prerequisites would be improve efficiency and reduce legal cost.

114. Even if the internal rules are clear, and, as such, not a source of legal uncertainty, conflicting requirements might still be a challenge for the parties but not a source of legal uncertainty. However, where netting agreements are intended to be transferred across jurisdictions, the issue turns into considerable legal risk.

Example 7 [74]*: A-Bank is a global bank headquartered in Country X. It is party to a netting agreement with B-Bank, also a global bank, which is headquartered in Country Y. It is also party to a netting agreement with B-Bank's small subsidiary (legally independent) in Country Z. The rating of the subsidiary deteriorates in the financial crisis and it is decided to merge it into the B-Bank parent company. Naturally, all financial contracts and netting agreements are supposed to travel by means of legal succession from Country Z (subsidiary) to County Y (parent). However, A-Bank starts worrying because the insolvency law of Country Y is quite distinct from that of Country Z, in respect of netting agreements. In particular, Y-Law does not recognise certain financial contracts as eligible to be included into netting agreements. Further, netting is only shielded against cherry picking to the extent that the covered financial contracts are registered with a repository and it is not clear whether this can be done retroactively. A-Bank tries to terminate the agreements with B-Subsidiary. However, merger is only regarded as termination event to the extent that it leads to a downgrade of the counterparty. In this case, the merger leads to an upgrade. A-Bank cannot terminate.*

115. It is true that cross-border mergers (of parent and subsidiary or of two totally unconnected financial institutions) do not happen frequently. But if a transaction of the kind illustrated above occurs, the enforceability of netting agreements is endangered for all sorts of reasons, i.e. not only as regards eligible contracts and formalities, but also in respect of the question of eligible parties[75] and even in relation to the core-mechanisms protecting the enforceability of netting.

V. The need for a harmonised framework in respect of general enforceability of netting

116. The analysis of the state of enforceability of netting in respect of general insolvency and commercial law leads to the following 4 Imperatives:

Imperative 1-A: Availability and enforceability of netting in all financial markets

117. There is agreement, notably amongst the regulatory community, that netting is one of the primary risk mitigation tools and therefore should be available in all financial markets.[76] This regulatory suggestion is the basis on which the analysis in this paper is built.

Imperative 1-B: A clear and compatible conflict-of-laws regime regarding close-out netting

118. As shown above, various details of the conflict-of-law framework and its operation are unclear. To the extent differences between the various conflict-of-laws regimes lead to uncertainty, they should be harmonised.

Imperative 1-C: Harmonisation of the understanding of netting and the mechanism protecting its enforceability

119. Significant differences exist in connection with the understanding of the concept of netting and as to the concrete legal mechanism protecting its enforceability in insolvency. The uncertainty flowing from incompatibility in this area can have a particularly high impact: the nature of the uncertainty, under certain circumstances, may cause the entire netting mechanism to be annulled. A satisfactory solution cannot be achieved by virtue of clarifying rules of private international law alone.

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[74] I am grateful to Holger Hartenfels who provided the inspiration for this example.

[75] Cf. also Example 19 on p. 80.

[76] Cf. 'Why enforceability of netting agreements matters', p. 18 et seqq.

Imperative 1-D: Clarification/harmonisation of the lists of eligible parties, eligible contracts and of formalities

120. In many cases, the lack of clarity of the domestic rules on eligible parties, eligible contracts and in relation to formalities required to render netting enforceable causes nuisance and high legal cost for the parties, sometimes legal risk. The lists of parties authorised to enter a netting agreement and of eligible financial contracts should be clarified. Mechanisms to make declarations or otherwise publicise any formal requirements should be set up.

121. Cross-border transfer of netting agreements requires the lists of eligible parties and eligible contracts to be harmonised. Formalities equally need to be harmonised or abolished.

2nd Part – Enforceability and regulatory bank resolution powers

122. Since the 2007/2009 financial crisis it has become clear that while the operation of netting brings advantages, it may also carry significant disadvantages in times of pressure on the financial market. To address this problem, special regulatory powers[77] relating to bank resolution have recently been the focus of interest. Relevant measures include, in particular, the transfer of the assets of a troubled financial institution ('ailing institution'[78]) to a solvent financial institution ('bridge institution'[79]) and a simultaneous moratorium on netting arrangements, plus a number of ancillary measures.

123. It is obvious that these powers are closely intertwined with the issue of enforceability of netting agreements. Thus, apart from the elements discussed in the 1st Part of this report, this new situation requires *additional* adjustments of the legal framework with a view to avoiding cross-jurisdictional conflicts in the area of private, commercial, property and insolvency law relating to netting. Therefore, in this third 2rd Part, our analysis will concentrate on the following issues:

- The findings of a recent project run under the auspices of the Basel Committee, the *CBRG Report and Recommendations*, which promotes the introduction of regulatory powers to transfer assets from an ailing institution to a bridge institution and the possibility of regulatory moratoria on netting, alongside a number of safeguards protecting the enforceability of close-out netting provisions (*infra*, section I). These recommendations have been taken up and developed further by a number of countries in 2008-2010 and are also reflected in a 2011 consultation paper of the European Commission[80].

- A short definition of the scope or this report, i.e. which aspects belong to regulatory policy and therefore fall *outside* its scope, as opposed to questions relating to insolvency, commercial and property law which fall *within* the scope of this study (*infra*, section II).

- Examples of national legislation already matching the findings of the CBRG report (USA, UK, Germany, Belgium, *infra*, section III).

- A core-analysis of this part of the study, pertaining to the question of why regulatory transfer, moratoria, etc. would need to provide for appropriate cross-jurisdictional effects in respect of close-out netting (*infra*, section IV).

- Thoughts about possible international solutions (*infra*, section V).

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[77] For the purposes of this report it is irrelevant whether such powers are allocated to the regulatory or to the prudential/supervisory authority. For ease of reference, I use 'regulatory'.

[78] This report employs the term 'ailing institution', others refer to 'failing bank', 'debtor', 'troubled financial institution', etc. The personal scope is still unclear. Banks seem primarily seem to be in the focus, but not exclusively. The ideal regime for non-bank financial institutions, financial market infrastructures and entities which do not provide any kind of financial service has not yet been identified. Also, the relevant point in time for regulatory intervention (pre- or post insolvency?) is not clearly described. The Basel Committee CBRG Report at [116.] suggests that the regulatory tools apply prior to or after the ailing institution enters insolvency or similar procedures, which would need to be looked at carefully, as the (cross-border) legal framework changes radically once the moment of the opening of a formal insolvency proceeding has passed. Therefore, the term 'ailing institution' is a stopgap, awaiting clarification of the scope of the relevant regulatory powers.

[79] Similarly, the term 'bridge institution' in this report is employed in a non-technical sense. It describes a legal entity to which the business of the ailing institution is transferred, regardless of who is the owner, what are its purposes, whether it has a banking licence, or what is its statutory framework. The institution could be a private sector purchaser or a publicly owned institution, whether already existent or to be established ad hoc. National legal frameworks follow different solutions and use different defined terms.

[80] Technical Details of a Possible EU Framework for Bank Recovery and Resolution, European Commission DG Internal Market and Services Working Document, January 2011, hereinafter ‚EU Commission Bank Recovery and Resolution Working Document'; http://ec.europa.eu/internal_market/consultations/docs/2011/crisis_management/consultation_paper_en.pdf.

I. CBRG Recommendations[81]

124. The Basel Cross-border Bank Resolution Group (CBRG) submits that unrestricted close-out netting on the occasion of a bank resolution might, under certain circumstances, constitute a significant additional threat to the stability of the financial market and therefore needs to be addressed by legislative and regulatory measures.[82]

125. The CBRG's critical review of the role of netting agreements takes its starting point in the idea of transfer of assets: in relevant cases of bank failures, it is preferable to transfer the ailing institution's viable financial contracts to a solvent bridge institution and thereby save the viable part of the business. In this way, market fears regarding certainty and continuity of transactions can be damped. The ailing institution can be wound up in an orderly fashion; its insolvency (or whatever other procedure applies) affects far fewer counterparties and involves significantly smaller volumes.

126. However, there are concerns regarding the automaticity of termination and close-out of non-performed contracts upon the occurrence of an enforcement event. The enforcement event, as defined in the netting agreement, may be any event, i.e. not only insolvency of the counterparty but also simple default, the appointment of an administrator, the intervention of state authorities, change of control, or any other pre-insolvency event.[83] Its occurrence may trigger the simultaneous close-out of large volumes of financial contracts. If a market player is in distress, such a large volume close-out, first, may undermine the purposes of the transfer to a bridge institution, and, second, may pose a systemic risk in itself[84]. The situation may become highly precarious where a regulator perceives the need to act with a view to breaking up an ailing institution despite knowing that its intervention is capable of triggering the simultaneous close out of large parts of the ailing bank's business. In other words, at the very moment the regulator steps in to save a struggling bank, there may be nothing left on the balance sheet to rescue. Thus, any systemic implications flowing from that situation would be difficult to avoid at that stage.

127. The CBRG paper therefore recommends that:

- regulatory authorities should have the power to transfer the assets of the ailing institution to a bridge institution;[85]
- there should be the possibility of a moratorium, or 'stay', on the close-out and termination in order to allow an orderly decision on whether and how the ailing institution's financial contracts should be transferred;
- after the transfer, termination and close-out should be precluded in respect of those contracts that have been transferred to the bridge institution, whereas they should be allowed in respect of contracts that have remained in the ailing institution's estate.[86]

[81] Cf. Basel Committee CBRG Report, pp. 40-42 (Recommendation 9); cf. also EU Commission Bank Recovery and Resolution Working Document, January 2011, Sections G and H.

[82] Cf. Basel Committee CBRG Report [115.]; EU Commission Bank Recovery and Resolution Working Document, January 2011, Section G1.

[83] Cf. supra, p. 16.

[84] 'This fire sale valuation will transmit the debtor's instability far beyond its counterparties', Basel Committee CBRG Report, [115.].

[85] Basel Committee CBRG Report, [116.]; EU Commission Bank Recovery and Resolution Working Document, January 2011, Section G3.

[86] Cf. Basel Committee CBRG Report, Recommendation 9; EU Commission Bank Recovery and Resolution Working Document, January 2011, Section G13.

These, then, should be the basic tools to be given to regulators.

128. The problem is not so much that of introducing these tools at a domestic level, since similar powers are already part of the insolvency procedure and regulatory environment anyway. Rather, from the point of view of this analysis, the major difficulty is that of introducing the possibility of transfer and moratorium, on the one hand, while avoiding the risk of undermining the practical reliability and legal certainty of netting agreements, on the other hand.[87] The certainty that netting agreements will be preserved is not only important in the relevant case itself; it is also vital from a general point of view, given the function of netting as a risk mitigation and risk management tool, including its role in determining capital requirements.[88] And last but not least, the financial market is a global market, hence a purely domestic view of these questions is clearly insufficient.

129. Drawing on the CBRG report, the following factors determine whether efficient regulatory powers (transfers, moratoria) and reliable netting agreements can co-exist:[89]

- the power of the regulator to halt the enforcement of the netting agreement by imposing a moratorium should be restricted to a limited and clearly defined timeframe, after which close-out netting would be possible in respect of those contracts that remained in the ailing institution's estate;

- the contracts should be transferred as a whole or not at all, with no option to pick out individual contracts with the same counterparty;

- the termination event that occurred in the sphere of an ailing institution does not produce its effect as against the new (solvent) bridge institution; however, if a termination event subsequently occurs in respect of the bridge institution, the original terms of the netting agreement apply;

- the regulatory powers should be designed in such a way as to preserve the safe and orderly operation of netting arrangements used by central market infrastructures, such as clearing systems.

II. Scope of the analysis

130. Various countries now have relevant legislation in place. In the context of enforceability of netting, the following legal issues have been identified as problematic by national legislators: (a) partial transfer of the ailing institution 's property[90], (b) interplay with foreign law; and, (c) any unintended consequences of a moratorium.

131. In the USA, a legal regime addressing the issues described above has existed for several years. A small number of other jurisdictions followed suit during or in the aftermath of the 2007-2009 financial crisis, notably the UK in 2009 and Germany and Belgium in 2010. The EU Commission submitted the aforementioned consultation paper in January 2011, drawing on the work of the CBRG and the legislative experience in its Member States.

132. However, these achievements may not suffice.

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[87] Cf. Basel Committee CBRG Report, [117].

[88] Cf. supra, p. 19 et seqq.

[89] Cf. Basel Committee CBRG Report, Recommendation 9 (p. 42); EU Commission Bank Recovery and Resolution Working Document, January 2011, Sections G13, H1-H5.

[90] Which as such is not relevant to this analysis, cf. Excursus on partial transfers, infra, p. 65.

133. First, *all* relevant markets would need to have a predictable regime in place providing for *ex ante* certainty as to whether transfer and moratorium were part of the regulator's toolbox. However, this can only be achieved by implementing relevant tools in all jurisdictions with a significant financial market. This is a matter of regulatory policy and as such falls outside the ambit of this study.

134. Second, the regulatory/supervisory framework would need to be co-ordinated amongst jurisdictions, at least to some extent. Considerable effort has been made in the past and fresh endeavours are underway to align the relevant regulation not only in the EU but also on a global scale. However, this issue likewise falls outside the scope of this paper.

135. Third, the interplay between the new regulatory tools and netting agreements has not been sufficiently explored so far.

- On the one hand, there is a danger that a moratorium or transfer (or both) might 'invalidate' a netting agreement (domestically or cross-border). Such legal uncertainty can easily raise doubts as to the general enforceability of netting agreements in comparable situations (knock-on effect).

- On the other hand, it is unclear whether the fact that financial contracts concluded by an ailing institution with another institutions are bundled by netting agreements might weaken the effect of the regulatory powers of transfer and moratorium.

136. The CBRG Report and the relevant national legislation in the US, the UK and Germany include a number of safeguards in this respect, which are also taken up in the recent EU Commission Working Document. These two issues directly regard the enforceability of netting agreements in insolvency proceedings and therefore fall within the scope of this study.

137. The analysis commences with a bird's-eye view of the measures already in place in a number of jurisdictions.

III. Examples of national legislative frameworks

United States of America

138. Title II of the Dodd-Frank Act provides for a new regime to liquidate ailing 'financial companies' that are systemically important and therefore pose a significant risk to financial stability.[91] The regime basically covers banks and bank holding companies but also, under certain conditions, non-banks.[92]

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[91] Cf. Section 204(a), Dodd-Frank Wall Street Reform and Consumer Protection Act; Public Law 111-203 of 21 July 2010, hereinafter referred to as 'Dodd-Frank Act'; http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_bills&docid=f:h4173enr.txt.pdf.

[92] Cf. Sections 201(a)(11), 203 Dodd-Frank Act. Similar rules exist and existed before the enactment of the Dodd-Frank Act in the USA, notably in the Federal Deposit Insurance Act (FDIA). However, these were suitable only for not-systemically-relevant financial institutions. A presentation of which types of financial institution are covered by which of the four different winding-up or insolvency procedures can be found in McDermott, Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 2 et seqq.
http://www.skadden.com/newsletters/FSR_A_Analysis_Orderly_Liquidation_Authority.pdf.
The provisions of the Dodd-Frank Act dealing with termination or repudiation of contracts, and the treatment of qualified financial contracts, are modelled after the FDIA, whereas provisions that empower the FDIC to avoid and recover fraudulent transfers, etc., were drawn from the US Bankruptcy Code: FDIC, Notice of proposed rulemaking, US Federal Register Vol. 75, 64173, 64175 (2010).

139. At the start of the liquidation process, the competent authority is appointed receiver. From this moment on, it takes control of the ailing institution and the liquidation process. It succeeds to all rights, titles, powers and privileges of the ailing financial institution and takes over its entire operations.[93]

140. The competent authority may organise a bridge financial institution.[94] This institution may immediately and by the operation of law succeed to and assume any rights, powers, authorities, or privileges of the covered financial company with respect to which it was established. There is no need for any further approval, assignment, or consent in this respect.[95] The competent authority may also merge the ailing institution with another financial institution.[96]

141. Likewise, any assets or liabilities of the ailing financial institution may be transferred to a solvent institution without prior consent, assignment or approval. This power extends to any assets and liabilities held by the ailing financial institution for security entitlement holders,[97] any customer property, or any assets or liabilities associated with any trust or custody business.[98]

142. As regards **partial transfer**, the Act provides that in transferring the ailing financial institution's assets or liabilities (and this includes any 'qualified financial contract'),[99] the competent authority shall:

- either transfer the entire bundle of assets and liabilities between the ailing institution and any person or any affiliate of such person. This bundle includes qualified financial contracts and related claims as well as related collateral. A master agreement is treated as one single qualified financial contract to the extent that it contains qualified financial contracts;[100]

- or, as an alternative to such comprehensive transfer, transfer none of the above and leave everything in the estate of the ailing financial institution.[101]

143. As regards the possibility of imposing a **moratorium**, the Act provides that:

- a solvent counterparty to a qualified financial contract cannot terminate or net such a contract solely by reason of the competent authority taking over the operations of the ailing institution, until 5 p.m. of the following business day;

- equally, termination and netting are excluded once the qualified financial contract has been transferred to a solvent institution and the counterparty has been informed accordingly;[102]

- apart from these cases, termination and netting rights are enforceable.[103]

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93 Cf. Section 210(a)(1)(A) and (B) Dodd-Frank Act.

94 Cf. Sections 210(a)(1)(F), 210(h)(1)(A) Dodd-Frank Act [p. 1496].

95 Cf. Section 210(h)(2)(E) Dodd-Frank Act.

96 Cf. Section 210(a)(1)(G) Dodd-Frank Act.

97 The interest received when holding securities through US intermediaries, cf. Article 8 Uniform Commercial Code.

98 Cf. Section 210(a)(1)(G) Dodd-Frank Act.

99 Defined as securities contract, commodity contract, forward contract, repurchase agreement, swap agreement or similar agreement which the competent authority determines falls into that category, cf. section 210(c)(8)(D) Dodd-Frank Act.

100 Cf. Section 2010(c)(8)(D)(viii) Dodd-Frank Act.

101 Cf. Section 210(c)(9)(A) Dodd-Frank Act.

102 Cf. Section 210(c)(10)(B) Dodd-Frank Act.

144. In respect of the involvement of **foreign law**, the rule is that qualified financial contracts (and related assets and liabilities) shall not be transferred to a foreign bridge institution under foreign law, unless the contractual rights of the parties of such qualified financial contracts are enforceable under that law substantially to the same extent as under the relevant provision of the Dodd-Frank Act itself.[104]

145. As regards the **integrity of netting agreements**, in exercising its right to repudiate qualified financial contracts to which the ailing institution is a party, the competent authority must either repudiate all financial contracts concluded with that party and its affiliates or none of them.[105]

United Kingdom

146. The UK Banking Act 2009[106] provides for a special resolution regime for banks. Those of its provisions that are of interest for the purpose of this paper include three options aimed at stabilising ailing institutions: transfer to a private purchaser, transfer to a bridge bank,[107] or transfer to temporary public ownership. These stabilisation options can be achieved by transferring either the ownership of the ailing institution (i.e. its shares) or its assets (property, rights and liabilities on its balance sheet) to one of the aforementioned acquirers by virtue of regulatory powers.[108,109] The following summary focuses on the power to transfer the assets of an ailing institution to one or the other receiving entity. The transfer of assets is also the focus of special secondary legislation: the UK Safeguards Order[110] which supplements the rules on property transfer contained in the special resolution scheme of the UK Banking Act 2009.

147. Under the Act, power to transfer property, rights and liabilities of the ailing institution to the receiving entity may relate to all or part of the assets of the ailing institution. Such power expressly covers property located outside the United Kingdom and rights and liabilities arising under the law of a foreign country.[111]

148. As regards the possibility of imposing a **moratorium**, the regime is as follows:

- The competent authority may provide that the property transfer is to be disregarded in the event of application of default event provisions.[112] In other words, the transfer would not trigger, in particular, termination rights, conditions precedent to performance, etc.[113]

[103] Cf. Section 210(c)(8)(A) Dodd-Frank Act.

[104] Cf. Section 210(c)(9)(B) Dodd-Frank Act.

[105] Cf. Section 210(c)(1) and 210(c)(11) Dodd-Frank Act.

[106] Banking Act 2009, of 12 February 2009; http://www.legislation.gov.uk/ukpga/2009/1, hereinafter referred to as the 'UK Banking Act 2009'.

[107] 'Bridge bank', under the UK regime, is a defined term and refers to a company wholly owned by the Bank of England (central bank), cf. Section 12(1) UK Banking Act 2009.

[108] Cf. Section 1(2)-(4) UK Banking Act 2009.

[109] The Bank of England (central bank), the UK Financial Services Authority and the UK Treasury all play a role in the operation of the special resolution regime, cf. s. 1(5) UK Banking Act 2009. This analysis continues to refer to 'competent authority' as the distribution of competences is irrelevant in this context.

[110] Statutory Instrument 2009 No. 322, The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 of 19 February 2009; http://www.legislation.gov.uk/uksi/2009/322/made; as amended by Statutory Instrument 2009 No. 1826, of 8 July 2009, referred to as the 'UK Safeguards Order'.

[111] Cf. Sections 33, 35 UK Banking Act 2009.

[112] Cf. Section 38(6) UK Banking Act 2009.

[113] Explanatory notes to the Banking Act 2009, http://www.legislation.gov.uk/ukpga/2009/1/notes, paragraphs 104, 67.

stipulated in the documentation used by the ailing institution and its counterparties if and to the extent provided for by the competent authority.

- However, in case of a *partial* property transfer, the competent authority cannot provide that the transfer is to be disregarded as a trigger for a default event provision if (in simplified terms) the relevant financial instruments are included in a set-off or netting or title transfer collateral arrangement.[114] This, in essence, means that netting and set-off rights are enforceable in the event of a partial property transfer. There is, however, an obligation to transfer complete netting packages (*cf. infra*).

- A partial property transfer is void in so far as it is made in breach of the aforementioned rule.[115]

149. The legislation recognises that the inclusion of assets governed by **foreign law** may be problematic: [116]

- If a regulatory property transfer instrument transfers property located outside the UK or rights and liabilities arising under a foreign law, the transferor and the transferee (i.e. the ailing institution and the receiving institution) must each take any necessary steps to ensure that the transfer is effective as a matter of foreign law, if not wholly effective already by virtue of the regulatory property transfer.

- Until the transfer of property, rights or obligations is effective under foreign law, the transferor (the ailing institution) must hold such assets for the benefit of the transferee (the receiving entity) or discharge its liability on behalf of the receiving entity, against reimbursement of expenses.

150. The Act recognises the significant potential of **partial property transfers** to interfere with market participants' vital interests, including netting and set-off arrangements and security interests.[117] Therefore, the competent authority is given the power to restrict, by way of secondary legislation ('order'), the making of a partial property transfer, or to attach conditions or specific provisions to it, and to provide for contravening partial transfers to be void or voidable.[118] Furthermore, the competent authority may provide, by way of secondary legislation, for special

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[114] Cf. Sections 9 UK Safeguards Order. However, in order to allow sufficient flexibility to carry out partial transfers in the interests of financial stability and depositor protection (HM Treasury, Banking Act 2009 Code of Practice, paragraph 7.14), the order upholds the possibility to exclude netting and set-off in relation to 'excluded rights' and 'excluded liabilities' which comprise rights and liabilities in connection with (basically) retail deposits and subordinated debt issued by the ailing institution or the ailing institution's counterparty; cf. Section 1(3) UK Safeguards Order. The carve-out relating to subordinated debt is aimed at preventing subordinated debt from being available for set-off in circumstances which could in effect make it 'senior' to other debts of the ailing institution, Mayer-Brown¸ Understanding the new financial reform legislation, p. 5.

[115] Cf. Section 10 UK Safeguards Order.

[116] Cf. Section 39 UK Banking Act 2009. Section 36(1)(a) opens the possibility that a transfer order 'may provide for the transfer to be or to be treated as, a succession'. E. Avgouleas, ibid., p. 219 regards this provision as an important tool permitting a valid transfer. I concur with this analysis: the provision could be used to allow for a valid transfer of foreign property. However, it is unclear whether Section 36(1)(a) is intended for that purpose. Neither the Special Resolution Regime Code of Practice of the UK Treasury nor other relevant documents or other authors seem to make that connection, cf. for instance P. Bierley, The UK Special Resolution Regime for Failing Banks in an International Context, Bank of England Financial Stability Paper No. 5. Further doubts arise from the context ('Continuity') in which the provision is situated.

[117] Cf, HM Treasury, Code of Practice, paragraph 7.4. Partial transfer is provided for in detail under Section 33(2) UK Banking Act 2009. The most likely use for this power is to transfer the 'good' part of an institution's business to a new entity – either a private sector purchaser or a bridge bank – with a 'residual bank' left behind, containing any assets and liabilities that are not transferred, or to move certain liabilities and 'bad' assets to a bridge bank, leaving the residual company solvent, HM Treasury, ibid., paragraph 7.2.

[118] Cf. Section 47(2) UK Banking Act 2009.

protection of security interests, title transfer collateral arrangements, set-off arrangements or netting arrangements[119], where, in addition to the above, the competent authority can provide for 'other consequences, including automatic transfer of other property, rights or liabilities, to arise, if or in so far as the partial property transfer is made or purported to be made in contravention of a provision of the order'.[120] The UK competent authority has made use of this power by enacting the Safeguards Order.[121] In a first group of rules, the Order provides that:

- rights and liabilities that are included in a set-off, netting or title transfer collateral arrangement can only be transferred as a package.[122] If a partial property transfer has been made in contravention of this rule, the exercise of the right to set-off or net is not affected;[123]

- a secured interest and the relevant asset provided as security may not be separated by a partial transfer.[124] If a partial property transfer has been made in contravention of this rule, there would appear to be no specific safeguard and in so far the general remedy mechanism applies (re-transfer, compensation);[125]

- property, rights or liabilities that form part of a structured finance arrangement (in particular covered bonds and securitisation vehicles[126]) may not be separated by a partial transfer.[127] If this rule is broken, the general remedy mechanism applies, *cf. supra*;

- property, rights or liabilities should not be included in a partial transfer order if to do so would result in modifying the operation of or rendering unenforceable transactions conducted in central market infrastructures such as clearing houses and stock exchanges. A partial property transfer is void if it is made in contravention of the aforementioned rule.[128]

151. It is important to note that in all cases described above, and in relation to the application of the Order in general, a transfer order that purports to effect a transfer of all assets is treated as such, even if some of the assets have not been properly transferred (or if there is uncertainty as to

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[119] Cf. Section 48 UK Banking Act 2009.

[120] Ibid., last indent in sub-section 2.

[121] Cf. supra, fn. 110. 'Nonetheless, even this arrangement has attracted strong opposition from the industry, which requires the exclusion of set-off and netting agreements from most of the 'carve outs' proposed in the draft Order, in order to avoid cherry-picking, legal uncertainty and unequal regulatory capital treatment. This position is, of course, reasonable, as it creates certainty of law in relevant financial transactions, especially as regards set off and netting arrangements which cover 'foreign property', given also the possible conflict-of-laws issues which may arise in this context. However, industry's view is also impractical not only in the context of partial transfers under the SRR but also in the context of using, in a voluntary manner, a 'bad bank' facility in order to separate well performing from distressed bank assets', E. Avgouleas, Banking Supervision and the special resolution regime, Capital Markets Law Journal Vol. No. 2 (2009), 201, 219.

[122] Cf. Sections 3(1),(3) UK Safeguards Order.

[123] Cf. Section 11 UK Safeguards Order, which is lex specialis regarding contravention of any safeguards in relation to set-off and netting: set-off and netting remain possible despite the partial property transfer by which the netting package is separated. As a consequence, there is no need for the remedies provided for under Section 12 (re-transfer or compensation). However, regard has to be had to the details of the remedy provided for in Section 11; in particular, it is unclear to what extent the rule accepts the notion of the ailing institution's counterparty being worse off than it would have been without the partial property transfer.

[124] Cf. Section 5(2),(3) UK Safeguards Order.

[125] Cf. Section 12 UK Safeguards Order.

[126] HM Treasury, Banking Act 2009 Code of Practice, paragraph 7.17. The defined term employed in the UK Safeguards Order is 'capital market arrangement'.

[127] Cf. Section 6(1) UK Safeguards Order.

[128] Cf. Sections 7(1), 10 UK Safeguards Order.

their proper transfer) due to their being governed by a foreign law under which the transfer order has no or only partial effect.[129]

Germany

152. In Germany, following the recently adopted *Restrukturierungsgesetz* ('Restructuring Act')[130], new §§ 48a to 48s have been inserted in the *Kreditwesengesetz* ('Banking Act'), providing for regulatory measures including the transfer of financial contracts to a bridge institution and the possibility of imposing a moratorium in respect of the cancellation or termination of financial contracts.

153. The German Federal supervisory authority can order the transfer of an ailing institution's assets, including obligations, to a bridge institution. The prerequisite is that the very existence of the ailing institution is at risk, thereby threatening the systemic stability of the financial system, and that there are no other means at hand to eliminate that risk.[131]

154. A **partial transfer** of the ailing institution's assets is possible.[132]

– Financial contracts covered by a financial collateral arrangement can only be transferred together with the collateral, and *vice-versa.*

– The same applies to assets which are entered into a clearing system.

– Financial contracts covered by a netting agreement must be transferred jointly, as a package, and together with the netting agreement (and with the master agreement, if any).

155. As regards the possibility of imposing a **moratorium**, the rules provide for the following:

– from the moment of the relevant order being made, financial contracts cannot be terminated on account of the transfer;

– additionally, any termination clause to that effect is invalid.

– However, cancellation or termination remains possible on grounds other than the occurrence of the transfer order, in particular circumstances belonging to the sphere of the bridge institution, or where financial contracts and relevant collateral are not both included in the transfer order (which they should, *cf. infra*) and are therefore separated.[133]

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129 Cf. Sections 2(5), 3(4), 5(6), 6(4) UK Safeguards Order.

130 Gesetz zur Restrukturierung und geordneten Abwicklung von Kreditinstituten, zur Errichtung eines Restrukturierungsfonds für Kreditinstitute und zur Verlängerung der Verjährungsfrist der aktienrechtlichen Organhaftung (Restrukturierungsgesetz), of 9 December 2010. Overview of the new provisions: G. Bachmann, Das neue Restrukturierungsrecht der Kreditinstitute, Zeitschrift für Bankrecht und Bankwirtschaft, 2010, p. 459 et seqq.

131 Cf. § 48a (new) German Banking Act. This rule applies mutatis mutandis in the event of a contractually arranged transfer (in absence of a transfer order) of all or part of the ailing institution's assets to a bridge institution, in the context of an orderly reorganisation procedure, § 11 Gesetz zur Reorganisation von Kreditinstituten ('German Bank Reorganisation Act') which is a new creation under the Restructuring Act, (Fn. 130).

132 Cf. § 48k (new) German Banking Act. A similar rule can be found § 13 Bank Reorganisation Act (Fn. 131).

133 Cf. § 48g paragraph 7 (new) and § 48k paragraphs 1, 2 (new) German Banking Act.

156. The new regime pays particular attention to the transfer (or rather, the non-transfer) of financial contracts governed by **foreign law**.[134]

- Where assets are governed by a foreign law and the transfer order is not recognised under that foreign law, or its recognition under the foreign law is not clear, the ailing institution is bound to take any steps required under the foreign law for the transfer to be completed.

- In the meantime, the ailing institution must administer the relevant assets in the interests of the bridge institution, and both ailing and bridge institution are liable vis-à-vis each other as though the transfer had been properly made.

- In the event of the ailing institution's entering insolvency, any assets the transfer of which is not recognised under the foreign law do not form part of the estate available for the insolvency proceeding.

- Creditors in the insolvency proceeding cannot claim performance of any of the ailing institution's obligations the transfer of which is not recognised under the foreign law.

157. Also, the competent authority can order the **re-transfer** of certain assets to the ailing institution, if it deems it appropriate, with a view to reducing the systemic threat posed by the ailing institution.[135]

- Re-transferred assets are deemed never to have been transferred.

- Assets that are included in a financial collateral arrangement, assets that are entered into a clearing system or assets that are covered by a netting agreement cannot be re-transferred (*cf. infra*).

- If a creditor's claim that has been re-transferred is not in the end settled by the ailing institution, the bridge institution is liable only up to the amount the creditor would have received in the wind-down of the ailing institution, disregarding the earlier transfer.

- The competent authority can also re-transfer any financial contract which has been cancelled or terminated by a counterparty (actually or purportedly, and in breach of the moratorium described above), including potential rights and obligations flowing from the cancellation or termination. However, in the event of that financial contract being covered by a netting agreement, the re-transfer extends equally to all other financial contracts covered by the netting agreement, the netting agreement itself and the relevant master agreement (if any).

Belgium[136]

158. In Belgium, the Law of 2 June 2010 ('Reorganisation Act')[137] introduced new reorganisation measures, including a special resolution regime, for undertakings in the banking and financial

[134] Cf. § 48i (new) German Banking Act.

[135] Cf. § 48j (new) German Banking Act.

[136] I am grateful to my – Belgian – research assistant Joris Latui, for providing the first draft of this section.

[137] Cf. Loi visant à compléter les mesures de redressement applicables aux entreprises relevant du secteur bancaire et financier of 2 June 2010, amending, inter alia, the Belgian Banking Act of 22 March 1993.

sector. The Reorganisation Act amended, *inter alia*, the *Loi Relative au Statut et au Contrôle des Établissements de Crédit* ('Banking Act')[138].

159. The new regime applies under certain 'specific circumstances' if these are such as to threaten the stability of the Belgian or international financial system.[139] Under those circumstances, the Government may, in consultation with the relevant authorities, establish by Royal Decree any transfer in favour of the State or any other person, Belgian or foreign.[140]

160. A **partial transfer** is possible: the transfer may encompass the assets, liabilities of one or more branches and more generally, all or part of the ailing institution's rights and obligations.[141] For clearing institutions, it is specifically stated that these assets may include client assets.[142]

161. There are no special safeguards for the transfer of qualified financial contracts in the event of a partial transfer. The Banking Act does provide the following 'continuity provisions':

– a transfer may not trigger a modification of the terms of a contract concluded between a credit institution and one or several parties;[143]

– additionally, a transfer may not trigger the termination of such a contract, nor does it entitle any of the concerned parties unilaterally to terminate the contract;[144]

– finally, a catch-all clause provides that the State may take any other measures that are necessary for the proper execution of the transfer.[145]

162. The preparatory work to the Banking Act states that the above continuity provisions are intended to prevent contracting parties from terminating their contracts with the credit institution.[146]

163. As regards the completion of the transfer, the Banking Act provides that the property must be conclusively transferred once the courts have ruled that the transfer is in conformity with the law and that the compensation to the former owners is deemed equitable.[147]

164. In relation to **foreign law**, the Belgian legislation is silent except for one provision which states that all disputes that might arise as a result of these measures are subject to the exclusive jurisdiction of the Belgian courts, which 'only apply Belgian law'.[148]

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[138] Cf. Loi Relative au Statut et au Contrôle des Établissements de Crédit, of 22 Mars 1993 ; Belgian Gazette 19 April 1993, errata 2 June 1993.

[139] Cf. Art. 57bis § 1 (new) Banking Act.

[140] Ibid.

[141] Art. 57bis § 1, 1° (new) Banking Act.

[142] Cf. Art. 6 Reorganisation Act.

[143] Art. 57bis § 4, 2nd paragraph Banking Act.

[144] Ibid.

[145] Art. 57bis § 4, 4th paragraph Banking Act.

[146] Cf. Exposé des motifs, projet de loi visant à compléter les mesures de redressement applicables aux entreprises relevant du secteur bancaire et financier, 17.

[147] Cf. Art. 57ter § 8 Banking Act.

[148] Cf. Art. 57bis § 6 Banking Act.

IV. Why transfer and moratorium need to be legally effective across jurisdictional borders

165. The CBRG Report defines two overarching policy goals in the context of bank resolution and netting:

> first, that transfer and moratorium *must not* jeopardise the reliability and availability of netting agreements in the specific case and generally,[149] and
>
> second, that cross-jurisdictional inconsistencies in respect of netting *must not* render bank resolution ineffective.[150]

166. As regards the first issue, the CBRG Report proposes a number of measures (avoidance of partial transfers, moratoria limited in time, etc. (*cf. supra*)), whereas it is silent on the second issue. In the meantime, US, UK, German and Belgian legislation have tackled the problem and the EU Commission is consulting on the shape of an EU framework in this respect (*cf. supra*).

167. The following analysis forms the core of this part of the report. It explores the exact nature and the extent of cross-jurisdictional inconsistencies and verifies whether, and to what extent, they are resolved by existing concepts.

A. Cases of cross-jurisdictional inconsistency[151]

168. A regulatory property transfer or a moratorium authorised under a parliamentary law would probably be valid in most, if not all, jurisdictions even if it contrasted with (prior) general rules and principles of pre-existing insolvency, property or commercial law.[152] However, as soon as foreign

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[149] Cf. Basel Committee CBRG Report, [117.] and Recommendation 9 (p. 42).

[150] Ibid., [118.].

[151] There are three additional issues that are connected to the subject of this study but nevertheless fall outside its scope: **(A.)** 'walk away clauses', which is about the realisation of 'in the money' derivatives contracts. The question is whether statutory amendments or private sector review of market documentation should provide the means to facilitate the ability of a defaulting counterparty or its estate to realise the benefit of 'in the money' derivatives contracts (this issue is briefly mentioned in the Basel Committee CBRG Report, [118.] et seq. and Recommendation 9 in fine); cf. H. Ekué, Lehman Brothers: contrepartie dans des opérations sur produits dérivés, R de Droit bancaire et financier, 5 (2009), section 2-A-2; P. Wood, Set-off and netting, derivatives, clearing systems, 2007, section 1-037 et seqq. **(B.)** Affiliate banks and regulatory transfer: whether and how can the relevant regulatory powers apply to affiliates of banks that are themselves not subject to banking regulation even though they engage in financial contracts, in particular derivatives? Under the framework laws in place, it is highly questionable whether regulators are able to transfer contracts concluded by such an entity to a healthy entity (Draft Basel Committee CBRG Report, [115.] and footnote 25). **(C.)** Moratorium on unrelated contracts under domestic and foreign law: it might be unclear to what extent a moratorium has immediate repercussions for third parties not connected to the assets, rights and liabilities covered by the netting agreement. One example relates to the means by which the applicable law prevents the netting mechanism from operating. Where it does so by providing that the regulatory transfer does not constitute a default event or credit event in the sense of netting agreements (cf. the description of UK law, supra), it is doubtful whether this disregard of the transfer as a default event or credit event only produces effects in respect of contracts to which the bank is a party, or whether it does so also in respect of contracts between third parties. (Mayer-Brown¸ The banking act – the new special resolution regime for dealing with failing banks, p. 3). Example (after Mayer-Browne): Ailing bank issues bonds under is domestic X-law. A credit default swap sold by A to B under Y-law has that Ailing Bank bond as reference obligation. Ailing Bank defaults on the bonds. The competent authority in Country X, in accordance with its statutory powers, provides that it be disregarded as a 'credit event' under all the credit default swaps (including the one sold by A to B), disapplying the legal effects under the documentation of the credit default swaps. It comes to a court proceeding in Country Y on whether there was a default event under the credit default swap, or not.

[152] *Cf.* in respect of UK law E. Avgouleas, *Banking supervision and the special resolution regime of the Banking Act 2009: the unfinished reform*, Capital Markets Law Journal 4 (2) (2009), 201, 218.

law elements are involved, the application of the transfer could become very problematic and the situation 'will give rise to waves of litigation in foreign jurisdictions'.[153]

> 'Landsbanki, Glitnir and Kaupthing were party to a great number of foreign (non-Icelandic) law contracts, and had substantial foreign assets (particularly in the case of Landsbanki and Kaupthing). Counterparties to those contracts, and other stakeholders, have in many cases taken action without reference to the Icelandic legislation: for example, closing out ISDA master agreements, exercising rights of set-off or commencing proceedings outside of Iceland in order to attach local assets. Where the exercise of such set-off rights or the commencement of such proceedings is specifically prohibited by the Icelandic legislation, there have been real doubts as to whether foreign courts will recognise the Icelandic legislative overrides.'[154]

169. Where a regulatory authority intends to transfer a netting agreement including the covered financial contracts to a bridge institution and/or impose a moratorium on netting, it is highly likely that some of the covered assets, rights and liabilities are governed by a foreign law.[155]

170. The overarching question is therefore

> whether foreign-law-governed assets, rights and liabilities can, in a legally effective manner, be transferred to the bridge institution by virtue of regulatory powers in a manner recognised by a foreign court,
>
> *or*
>
> whether they cannot and therefore remain in the estate of the ailing institution, leading to their separation from those assets, rights and liabilities which are validly transferred
>
> *and*
>
> whether in the latter case appropriate legal or regulatory 'safeguards' are capable of remedying the separation of the netting agreements and parts of the covered contracts or cushion the negative consequences flowing from that separation.

171. There are a number of practical scenarios involving a foreign law element. Their occurrence depends either on the choice of law made by the parties, or on conflict-of-laws principles or on principles regarding the competency of courts and authorities. There are inconsistencies relating to both regulatory transfer and moratorium.

Transfer of securities collateral and 'Prima'

172. Securities (shares, bonds) are held in an account with a foreign intermediary, for example under a repurchase or securities lending transaction. In these cases, foreign law[156] applies to the proprietary issues of the securities under the 'place of the relevant intermediary' or 'Prima' principle which is now widely acknowledged.[157] In particular, the validity and enforceability of

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[153] E. Avgouleas, ibid., 218.

[154] Allen & Overy, Special Resolution Regime: Safeguards for Partial Property Transfers, January 2009, p. 2.

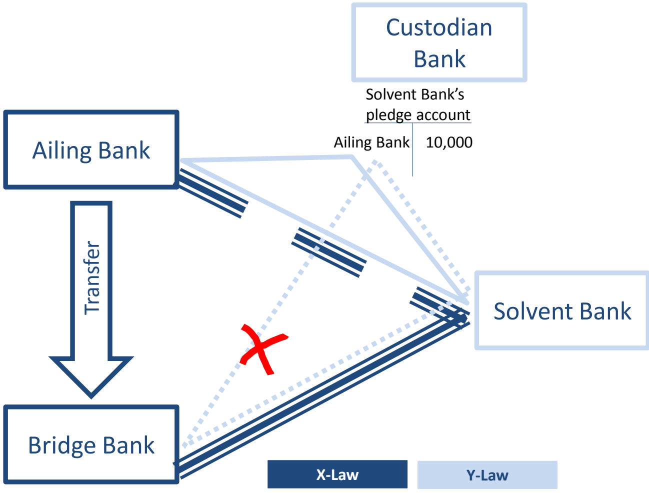
[155] Cf. HM Treasury, Special Resolution Regime, safeguards for partial property transfer, November 2008, p. 12, 2.11.

[156] The term 'foreign', in the following, denominates the law of a country other than the country the laws and regulations of which grant the power of regulatory transfer to the competent authority in the context of a resolution procedure.

[157] The basic rule is that the law of the account applies to the securities, instead of the law under which the securities are issued or the law of the place where the paper securities are located or the law of the place where the initial electronic record is made. There are two sub-species of Prima: either the law of the account is the

security interests created over the securities is governed by that foreign law. The same would apply in principle (though less relevant in practice in the present context) to movable and immovable property physically located in a foreign jurisdiction.

Example 8*: Ailing Bank is incorporated and headquartered in Country X, Solvent Bank in County Y. They have concluded a master agreement under X-Law under which Solvent Bank has provided security to Ailing Bank over a portfolio of securities held with Custodian Bank in Country Y. It is undisputed that Y-law applies to the proprietary aspects of these securities. Accordingly, encumbered securities have to be credited to a special sub-account opened in favour of the security taker for the security interest to be valid and enforceable. The parties and Custodian Bank have complied with this requirement. Later, Ailing Bank enters into a resolution procedure in Country X and the competent authority, on the basis of its statutory powers, orders a transfer of all assets, rights and liabilities of Ailing Bank to Bridge Bank. In respect of the encumbered portfolio, Custodian Bank cannot do anything without instruction given by Solvent Bank. The latter is uncertain about what to do and prefers to do nothing. The regulatory transfer becomes effective on a Monday morning but the securities are still credited to a sub-account opened in favour of Ailing Bank.*



173. In this scenario, the netting agreement has been transferred whereas the legal situation and attribution of the security collateral remain unchanged. As a consequence, the security collateral is separated from the remainder of the financial contracts bundled by the netting agreement, at least until Solvent Bank instructs Custodian Bank to make the appropriate changes to the sub-account. If the relevant securities collateral is subject to legal controversies, this might take time.

Transfer of a non-transferable credit claim

174. A credit claim might be governed, following the choice of the parties to the claim, by a foreign law. Questions as to how that claim is validly transferred are therefore governed by that foreign law and removed from the ambit of the law of the regulator.

175. For instance, a claim between the parties might not be transferable due to a contractual restriction which is governed by foreign law:

Example 9*: Ailing Bank is incorporated and headquartered in Country X, its debtor D in Country Y. Under the terms of the agreement, the claim against D is neither transferable nor capable of being encumbered in favour of a third person without D's consent. The clause is valid under the applicable Y-law. As before – D does not give its consent in time.*

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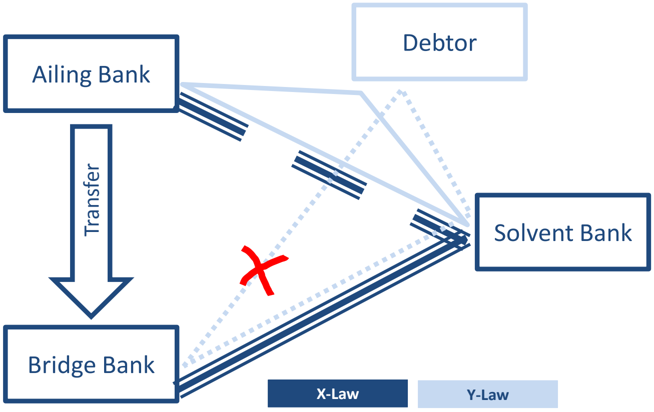
law agreed upon by the parties or the law of the account is the law of the place where the account is maintained.



176. Also, foreign statutes might prevent the transfer of a claim:

Example 10*: Ailing Bank is subject to X-Country's laws and regulations. It is debtor under a loan agreement with Creditor Bank of Country Y which is an affiliate of Solvent Bank which is located in the same country as Ailing Bank. Y-law is applicable to that loan. The loan is made for the account of Solvent Bank and included in a netting agreement between Solvent Bank and Ailing Bank. Later, Ailing Bank enters into a resolution procedure and the competent authority orders the transfer of all assets, rights and liabilities of Ailing Bank to Bridge Bank. In respect of Ailing Bank's debt owed to Creditor Bank, the latter's consent is necessary under Y-law for the transfer to Bridge Bank to be valid.*

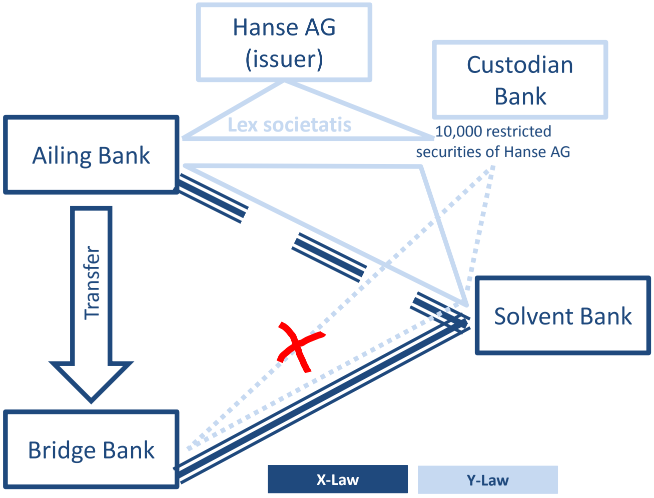
177. In these two examples, again, the legally effective transfer depends on the consent of a third party. In most cases, obtaining consent will be relatively straightforward. However, relatively unspectacular issues, for example of an operational nature, can delay everything, however briefly. If there is legal controversy surrounding the relevant assets, consent might not be given at all or only after court proceedings.

Transfer of securities and *lex societatis*

178. Securities are provided as security. In the case of shares, the law under which the issuer is incorporated (*lex societatis*) applies. The terms of the issue contain restrictions regarding transferability, etc.

Example 11*: Ailing Bank (of Country X) owns securities which are of the 'restricted registered'*[158] *type under Y-law and are provided as security to Solvent Bank. The entire relationship is covered by a netting agreement. Later, Ailing Bank enters into a resolution procedure and the competent authority orders a transfer of all assets, rights and liabilities to Bridge Bank. This particular type of securities requires the consent of the issuer for any transfer to be valid. As before – the consent is not given in time.*

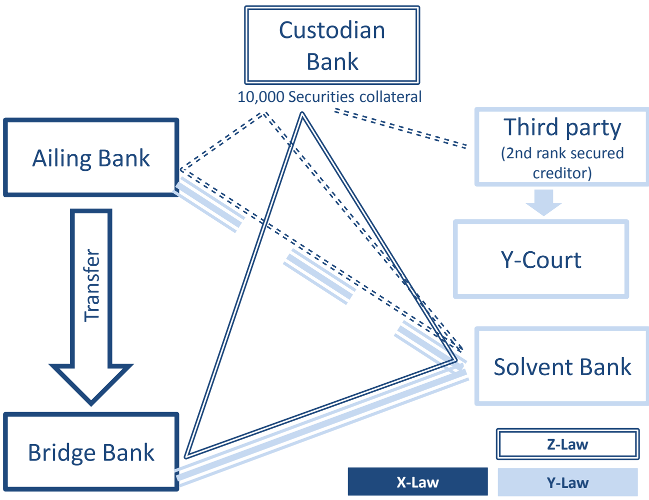
[158] Cf., for example, 'vinkulierte Namensaktie' under German law.



Transfer of assets covered by a foreign netting agreement

179. A netting agreement (as part of a master agreement or as a stand-alone) can be governed either by the domestic law of the ailing institution and its regulator or by the law of the counterparty, or even by a third law.

Example 12*: Ailing Bank is located and headquartered in Country X, Solvent Bank in Country Y. They have concluded a netting agreement. All their mutual financial contracts covered by that agreement are governed by Y-law. Later, Ailing Bank enters into a resolution procedure and the competent authority orders a transfer of all assets, rights and liabilities to Bridge Bank free from any encumbrance. However, certain security interests in securities are governed by Z-law and are therefore difficult to transfer (cf. the Prima scenario above). The netting package risks being separated. Y-law (applicable to the netting and master agreement) prescribes that in such cases, the entire netting package must remain in the estate of Ailing Bank. X-law (applicable to the resolution procedure) prescribes that the transfer can take place anyway and provides for a compensation scheme that would remedy any damage to Solvent Bank and third parties due to the assets that it was not possible to transfer. A third person with a second-rank security interest over the same assets (those governed by Z-law) files a lawsuit in Y-Country against Bridge Bank aiming at restitution of the assets.*



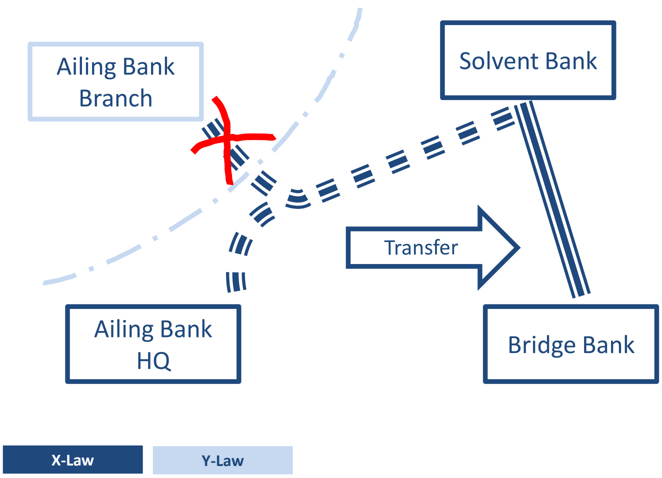
180. In this case, both jurisdictions cater for the case of foreign-law-governed assets. However, the solutions provided differ fundamentally – under the domestic solution the transfer would be valid, under the foreign solution it would not. The situation is complicated further by the fact that the netting agreement itself is governed by the foreign law. If a domestic court were to be seized,

it might hold that the transfer was effective. The legal situation is much less clear where a foreign court is seized by a foreign third party and conflict-of-laws principles point to the application of foreign law – the court might disregard the regulatory powers of the competent authority and treat the case as if the collateral had not been transferred effectively.

Transfer, territoriality and foreign branch

181. Transferability obstacles may also derive from foreign regulatory authority.

Example 13*: Ailing Bank is incorporated and headquartered in Country X. It has a branch (i.e. operations that legally form part of the ailing institution) in Country Y. Both Ailing Bank's headquarters and its branch have financial contracts with Solvent Bank of Country X which are all covered by one and the same netting agreement. When Ailing Bank, including its entire group, gets into severe financial difficulties, the regulatory authority of Country X commences resolution proceedings in respect of Ailing Bank, ordering the transfer of all assets, rights and liabilities to Bridge Bank. The competent authority in Country Y opens a (separate) winding-up procedure in respect of Ailing Bank's branch and declares that all assets, rights and liabilities which are in the name of the subsidiary form part of its estate, including those covered by the netting agreement with Solvent Bank.*



182. This classical scenario of ring-fencing exemplifies the wider implication of a universal or territorial approach to resolution and winding-up procedures in respect of banks.[159] There would seem to be no satisfactory solution for this problem. The competent authority in the first country cannot resolve a legally separate ailing institution in the second country purely by virtue of its domestic powers. Foreign regulators might not co-operate where the resolution powers of the competent authority of the first country are concerned. Such lack of co-operation might include a refusal to consent to, or even acknowledge, the transfer to a bridge institution.[160] In such a scenario, the assets governed by foreign law are separated from the remainder of the financial contracts covered by the netting agreement and there is no chance of their being re-united in the future, i.e. the separation is permanent.

183. The situation is different where the cross-border link consists in having a subsidiary (i.e., operations organised as a *separate* legal entity) in a second country.

[159] A detailed description of both approaches may be found in Basel Committee CBRG report, p. 16 et seqq.

[160] The Clearing House, Further Comments on Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions, Letter to the Federal Deposit Insurance Corporation, 11 January 2011, p. 8 et seq.

Moratorium on assets and netting agreement governed by foreign law

184. In the context of transfer, we have analysed the situation in which the law applicable to the netting agreement is different from the law under which the competent authority orders the transfer. Here, we put the parallel question in relation to a moratorium:

Example 14*: Ailing Bank is headquartered in Country X. Its counterparty, Solvent Bank, in Country Y. They have concluded numerous financial contracts which are covered by a netting agreement. All contracts are governed by Y-Law. Ailing Bank enters into a resolution procedure. The competent authority in Country X imposes a moratorium on close-out netting. Solvent Bank is of the opinion that the moratorium does not have any legal effect under the law of Country Y and proceeds to close out. It comes to a court proceeding in Country Y.*

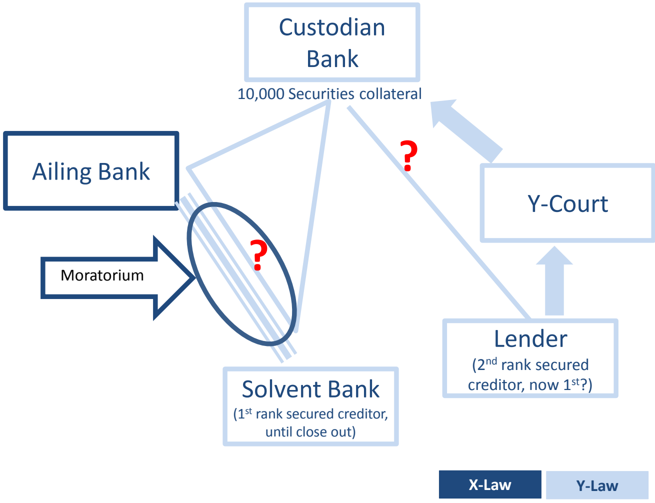
185. In this case, the court might tend to uphold the netting agreement and recognise the close-out. However, in such a two-party situation, the solvent party's opposition to the moratorium might be less relevant in practical terms, for two reasons: first, the solvent counterparty might be in the regulatory sphere (for instance through foreign branches or subsidiaries) of the ailing institution's competent authority and therefore be ready to co-operate. Second, there is a fair chance that the court will recognise the foreign moratorium. However, in the following, the scenario is developed further. The result might be much more problematic.

Moratorium and third party rights under foreign law

186. The situation appears to be even less clear where the court has to decide on the rights of third parties that are not directly linked to the ailing institution. In particular where third parties are involved and take legal action under the foreign law, the moratorium might not be recognised:

Example 15*: Ailing Bank is headquartered in Country X, its counterparty, Solvent Bank, in Country Y. They have concluded numerous financial contracts and collateral agreements which are covered by a netting agreement. The netting agreement contains an automatic termination clause*[161] *which is triggered by the opening of a regulatory resolution procedure, amongst other possible events. All arrangements are governed by Y-law which also applies to part of the collateral, notably a pool of securities held by Solvent Bank in Y-Country in an account maintained by Custodian Bank. When Ailing Bank enters into a resolution procedure, the competent authority in Country X orders that no netting can take place during the 48 hours following the opening of the procedure. Solvent Bank holds that the netting cannot be halted by the competent authority because Y-law applies and proceeds to close out. Lender L of Solvent Bank had a second-rank security interest over the same pool of securities. Solvent Bank itself enters financial difficulties. In a later court proceeding, L claims that it had a first-rank security interest since the netting mechanism had been put into place and that there was now no other security interest over the securities except its own.*

[161] Cf. supra, p. 15.



187. In this case, there is a significant possibility that the foreign court will look to foreign law and hold that the moratorium cannot halt the netting mechanism. If it did, L's protection under Y-law would have been invalidated by regulatory action under X-law.

B. Legal consequence: separation of financial contracts covered by the netting agreement

188. The first legal consequence of the above scenarios[162] is separation of parts of the financial contracts covered by the netting agreement. This is because, in many cases, the *de iure* attribution of assets, rights or liabilities to the ailing institution, the bridge institution or a third person does not reflect the attribution originally intended by the competent authority, essentially because not all prerequisites of the intended transfer are complied with.

189. We can infer from the above scenarios that the most common cases are:

– lack of consent, or other action, by a counterparty,

– lack of consent, or other action, by a third party, or

– lack of consent, or other action, or an adverse action undertaken by, a foreign authority or court.[163]

190. In a purely national context, any necessary act of consent, or other action, can be replaced by the transfer order on the basis of statutory powers exercised by the competent authority, attributed to it by law.

191. Also, in the national context, it is very unlikely that any national authority or court (e.g. an insolvency court) would take any decision that would adversely affect the regulatory transfer, given the supremacy of regulatory powers over the general rules of insolvency, property and commercial law, as intended by the legislator.

192. However, regulatory powers in the context of bank resolution might overwrite domestic *substantive* law but would not change the *private international law* framework. As a consequence,

[162] On the resulting threats for market participants and the market as a whole, cf. infra, p. 67 et seqq.

[163] Cf. Avgouleas, ibid., 217 et seq.: 'Most difficulties regarding a regulatory transfer probably flow from assignability or transferability restrictions, stemming from, for instance, lack of capacity or any legal, contractual or otherwise requirement of consent.'

foreign law continues to apply if and to the extent that the rules of private international law point to it. In respect of an action or consent of the counterparty, third party or foreign authority required under the applicable foreign law, this means that it *cannot* be overridden by the transfer order of the national regulatory authority. In other words, the latter cannot disapply the relevant requirement under foreign law, nor can it substitute the action or consent.

193. Likewise, any action by a foreign authority which contravenes a transfer order results in separation of parts of the financial contracts covered by the netting agreement. For instance, a foreign insolvency court order to include certain assets – which are governed by foreign law or are *de facto* located in the sphere of a foreign jurisdiction – in a foreign insolvency proceeding in respect of a branch obviously means that the national statutory powers of the competent home authority must remain without influence.

194. An ineffective moratorium allows (amongst other consequences) the netting mechanism to be operated in relation to only a part of the contracts originally covered, which is tantamount to separation.

Imperfect transfer

195. The most obvious consequence of the transfer scenarios described above is an 'imperfect transfer' from the ailing institution to the bridge institution. The resulting legal uncertainty affects the transferor (ailing institution), the transferee (bridge institution), and also third parties, e.g. a party having rights over property which is affected by the transfer without being itself counterparty to the ailing institution. The following consequences flow from this situation:

- The relevant assets remain, *de iure*, in the estate of the transferor. However, despite the fact that they remain in place, their legal position suffers from the transfer of the remaining, non-foreign-law-governed, assets, rights and liabilities. The transfer of the latter would be valid as the netting agreement is unable to keep the bundle of financial contracts covered by the netting agreement together against the force of the regulatory transfer order. This situation entails legal and operational risk for the parties to the netting agreement.

- An imperfect transfer might also frustrate the purpose of the regulatory action. In particular, in cases where the netting agreement is governed by foreign law, the regulatory action might trigger the termination of all or part of the non-transferred contracts at the moment when the netting bundle is separated, particularly if the efficacy of the moratorium is also questionable.

Purported transfer

196. An imperfect transfer might be a 'purported transfer'. In this case, assets, rights and liabilities are treated, *de facto*, as if they had been effectively transferred (in that the authority at the moment of the transfer is not aware of foreign law involvement). The following consequences might flow from this situation:

- The rights of the counterparty or the third party to whom the asset or right in the asset is attributed are imminently violated, without legal justification.

- If a third party subsequently challenges the situation in a court which correctly applies private international law rules, the invalidity of the transfer of certain assets and the separation of parts of the financial contracts covered by the netting agreement will become apparent (*n.b.*: the separation occurred *de iure* at the moment of the imperfect transfer).

- If, before the situation is clarified, a new termination event occurred in the sphere of the bridge institution and the netting mechanism operated as foreseen in the documentation, the (foreign-law governed) assets, rights and liabilities that were purportedly transferred would be 'terminated' and included in the computation of the net amount despite the fact that they have been *de iure* attributed to another person.

Time span of legal uncertainty

197. Uncertainty will even arise if the separation is only temporary. The transfer of the foreign-law-governed part of the assets, rights or liabilities might occur later in time (in particular, because consent is now given, etc.), thereby 're-uniting' a bundle of financial contracts covered by a netting agreement that had been legally separated before. However, in the meantime there is always a time window allowing for the occurrence of one or more of the scenarios described above, or similar ones. The length of the time span, in particular if legal proceedings are pending, may stretch to several months, during which time foreign-law-governed contracts are not transferred. It is probably fair to say that the restoration of the bundle of financial contracts covered by the netting agreement when there is such a time lag stands a good chance of failing, leaving the parties, any third parties and the market in disarray and even rendering the whole transfer pointless from an economic point of view.

The role of the *forum*

198. The situation might be different depending on whether a national or foreign court is seized of the matter. On the one hand, a national court might be more inclined to uphold the regulator's action and tend to not to interfere with it; from this point of view, the involvement of a national court would seem to be less problematic. On the other hand, however, were the domestic court to find that parts of a transfer were invalid, its ruling would be authoritative and well-nigh impossible for the domestic competent authority and other involved parties to overcome; from that perspective, a domestic court ruling can cause immense difficulty.

199. A foreign court, on the other hand, might be more sympathetic[164] to applying its rules of private international law in favour of a person claiming a violation of rights which are protected under the law of that court's country. However, there is a chance of its decision being ignored in the country of the regulatory transfer, i.e. its impact is comparably smaller. By contrast, in cases where regulators, foreign parties or foreign third parties have control over the relevant assets, as is the case with securities or securities collateral held in foreign accounts, the power of the foreign court's decision is nearly absolute.

200. Additionally, combining the two aforementioned arguments, there seems to be quite some potential for contradictory court-rulings.[165]

***Excursus:* partial transfer**

201. At a domestic level, much of the policy discussion surrounding regulatory transfers focuses on the issue of whether a partial transfer of the assets of an ailing institution should be possible, i.e. whether the instrument of transfer could be used to split the ailing institution into a 'good' and a 'bad' bank.

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[164] Avgouleas, ibid., 218: '[Courts] are unlikely to deem their own property, contract and consumer protection laws, often based on their Parliaments' Statutes, subordinate to the special resolution regime provisions'.

[165] Cf. a recent case of contradictory court rulings in a closely related matter (anti-deprivation rule): US Bankruptcy Court for the Southern District of New York in Lehman Brothers Special Financing Inc. vs. BNY Corporate Trustee Services Ltd., Case No. 08-1555, of 25 January 2010; and, English High Court in Perpetual Trustee Co Ltd. Vs. BNY Corporate Trustee Services Ltd & anor [2009] EWHC 1912 (Ch.).

202. A partial transfer might present several legal drawbacks:

First, the competent authority might 'cherry pick' from the estate, i.e. it might transfer only the most valuable assets of the bank to a third party, leaving just poor quality assets and all the liabilities in the residual bank.[166] Such a situation leads to unequal treatment of the ailing institution's creditors, who would have been better off had it gone into insolvency.[167] The debate surrounding the possibility of partial transfers therefore also touches on the attractiveness of a financial market place.[168] As this is a question of policy, it will not be pursued further in this paper.

Second, a partial transfer might itself separate financial contracts covered by the netting agreement by transferring some but not all of the assets, rights and liabilities covered by the netting agreement. The separation is conceptually comparable to the aspects described in the previous chapter with the important caveat that, as long as there are no cross-border elements involved, the negative consequences would be easier to address through appropriate remedies.

Third, foreign-law issues might impede the envisaged result (*cf.* the previous sections). This applies *mutatis mutandis* if only part of the ailing institution's assets, rights and liabilities is transferred. Partial transfers are in no way special in this respect.

203. Against this background, it would appear that partial transfers do not confer additional complexity on the questions addressed in this paper.

C. Market consequences: parties and third parties suffer from legal uncertainty; knock-on effects

204. The examples analysed in the preceding section show that an imperfect (or worse: purported) regulatory transfer or doubts as to the cross-jurisdictional effectiveness of a regulatory moratorium can potentially unsettle the ailing institution, the bridge institution, third parties with an interest in assets, rights and liabilities entangled in the situation, and indeed the market as a whole. Separation of bundles of financial contracts and netting agreements which can be operated contrary to a regulatory order present a number of risks, as follows.

Unavailability of enforceable netting

205. Originally, the netting agreement and all covered assets, rights and liabilities exist between the ailing bank and its counterparty. Following an imperfect transfer, some of these contracts remain in the ailing institution while others, probably – but not necessarily – including the netting agreement itself, are transferred to the bridge institution.

206. First, this situation entails that netting only applies to either the ailing institution or the bridge institution, depending on whether the netting agreement was effectively transferred or not.

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166 Mayer-Brown¸ The banking act – the new special resolution regime for dealing with failing banks, p. 4, providing the example of a valuable charged asset which is transferred to a third party free of the charge, but the liability remains with the transferor.

167 Avgouleas, ibid. 218; The Clearing House, ibid (Footnote 160), p. 7: 'claims against the failed financial institution, even if senior to other claims, will […] be subordinated to a large number of claims – including traditional administrative expenses, obligations under financing arrangements assumed by [the competent authority] claims of the [government] and others'.

168 'In fact, it was convincingly argued that the negative consequences which could flow from partial transfers would have negative implications for UK banks and financial markets, increasing their cost of funding and requirements for regulatory capital (where netting agreements are taken into account to lower levels of regulatory capital), ultimately leading UK banks to a loss of competitiveness', Avoulgeas, ibid.

If the netting agreement itself is governed by a foreign law there might be some doubt on this score. The general expectation would be for netting to be available between the counterparty and the bridge institution. If it is not, the counterparty will have a severe risk management problem. The legal uncertainty created by a purportedly transferred netting agreement is probably worse still.

207. Second, assuming that the netting agreement is where the transfer order expects it to be (i.e., with the bridge institution), the issue of the separated bundle of contracts remains. The netting agreement and part of the originally covered contracts exist between the counterparty and the bridge bank.

208. If a termination event were to occur in the sphere of the bridge institution, would the counterparty be able to close out and net? The first reaction is positive – why should the loss of part of the covered assets prevent the netting agreement from operating in relation to the remainder of the contracts?

209. However, there is a major concern that flows from parallel considerations in relation to one or more void or voidable contracts (gambling!) included in the bundle of financial contracts covered by a netting agreement: might not this situation lead to courts negating the enforceability of the netting agreement as a whole?[169] Conceptually, there is probably no difference between part of the contracts in the bundle being void or simply being 'absent'. Against this background, there appears to be a realistic chance that a court might question the enforceability of netting if the bundle of financial contracts was separated by an imperfect transfer. [170]

Deterioration of the assets and distortion of the net amount

210. During the period of separation, non-transferred assets or rights are liable to deteriorate or to devalue, or to get lost. This is the case in particular where the ailing institution, after transferring most of its viable assets, turns into a 'bad bank'. In many cases, it faces being wound up. As a consequence, the assets

- might be dragged into an insolvency or similar procedure, as they still form part, *de iure,* of the ailing institution's estate; or,
- could considerably change their value or even become worthless owing to their attribution to the ailing institution.

211. Afterwards, any attempt to 're-unite' the bundle of financial contracts covered by the netting agreement or otherwise remedy the separation would be futile.

212. If netting is still possible, the separation and/or the inefficacy of a regulatory moratorium cause the netting mechanism to cover only part of the assets, rights and liabilities which were originally included (*cf.* the preceding section). Securities collateral is particularly vulnerable to separation from the remainder of the bundle of financial contracts and hence to not being transferred (*cf.* 'regulatory transfer and prima', *supra*). The legal position of mark-to-market and top-up mechanisms, frequently found in standard market documentation, is uncertain.

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[169] Cf. supra, p. 25 et seq.

[170] There is a particularity to note in respect of the EU (Financial Markets Law Committee, Issue 133 – Banking reform, depositor protection – the special resolution regime, July 2008, p. 8 et seq.): In the 27 EU Member States, effective netting must be available in the context of collateral arrangements concluded by financial institutions (Financial Collateral Directive, Article 7 and Recitals 14, 15). If bank resolution measures have the potential of separating netting agreements, the relevant jurisdiction would probably not comply with its obligations under the relevant directive.

213. Also, the impact on the net sum resulting from the operation of the netting agreement is obvious. Where security collateral is not transferred and hence not comprised in the computation of the net amount, or where assets deteriorate because of an imperfect transfer, the outcome is likely to be substantially different from what it would have been if no transfer had occurred or the transfer had been a perfect one.

Capital requirements increased; liquidity absorbed

214. If netting is actually defunct, the value of separated financial contracts drops, and collateral mechanisms are defective, the parties' risk management becomes increasingly fraught. The major risk mitigation tools – netting and collateralisation – fail in relation to the assets, rights and liabilities subject to the imperfect transfer or ineffective moratorium. This would have immediate consequences in terms of capital requirements under the rules of Basel II.[171] Attempts to address this situation would suck up liquidity and tie capital.[172] Even the mere suggestion that it might come to an imperfect transfer and/or ineffective moratorium would have that effect. It is clear, however, that volumes matter and that in many cases, the volume of the affected assets, rights and liabilities will not necessarily be enormous. However, the possibility of many counterparties to an ailing or bridge institution facing the same difficulty simultaneously carries a significant risk.

Knock-on ('domino') effects

215. Often, the ailing institution will have a significant number of counterparties that would be affected by a regulatory transfer or moratorium. Uncertainty as to the general availability of netting in respect of the bridge institution (as their new counterparty) would provoke a simultaneous and structurally similar reaction by all parties involved. Chiefly, simultaneous steps will be taken to meet capital requirements. A very large number of financial institutions may be forced to curtail their lending activity, thereby depriving the market of liquidity.

216. The effect is not confined to the ailing institution and its counterparties. The market will turn uncertain in respect of all *comparable* upcoming situations, and unexpected court rulings in the home jurisdiction or abroad will also affect the perception of the legal certainty of comparable arrangements.

217. Legal uncertainty flowing from a purported transfer, if identified at a later stage, will have a particularly high detrimental impact because of the element of surprise, the time that has passed since the regulatory action, and sudden doubts in the market arising in relation to similar situations which have not yet been clarified.

D. Can domestic measures remedy legal uncertainty?

218. Most of the existing legislation in principle acknowledges that the effectiveness of transfers and moratoria can be impeded by the involvement of foreign law. The different resolution frameworks provide for certain remedies or 'safeguards' in a domestic context. However, the following analysis shows that these measures are only partly effective in providing for the necessary legal certainty as soon as foreign law elements become involved.

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[171] Cf. supra, p. 20.

[172] Cf. The Clearing House, ibid. (Footnote 160), p. 7.

Always keep the bundle of financial contracts intact

219. One, obvious, solution is never to separate the financial contracts in the first place. If it was not possible to transfer the bundle entirely because foreign law elements prevent some of the contracts being transferred, it should simply stay in the ailing institution's estate.[173]

220. However, netting agreements between two globally active institutions commonly cover a number of financial contracts comprising a cross-jurisdictional element. By not transferring netting agreements containing a foreign law element, the entire commercial relationship or, at the very least, the complete bundle of contracts covered by the netting agreement, respectively, would need to remain in the estate of the ailing institution.[174] Such a rule would cause a large proportion of the ailing bank's viable assets, rights and liabilities to be excluded from the possibility of transfer, thus clearly endangering the original purpose of the regulatory measures.

221. One proposal that has been mooted is to transform the ailing bank into the 'good' bank by transferring all 'toxic' assets, rights and liabilities to the transferee, turning the latter into the 'bad' bank.[175] Yet this would not solve the problem either since toxic assets might themselves contain a foreign law element. Moreover, policy considerations are likely to favour transfer of the viable rather than the toxic assets to the new institution.

222. Therefore, leaving the bundle consisting of the netting agreement and the covered financial contracts intact at the price of preventing its transfer to a bridge institution might jeopardise any rescue attempt.

223. If a rule prescribing that only netting agreements that do not include foreign law elements can be transferred were nevertheless decided to travel down that road, there would have to be a fall-back provision to cover the situation where the relevant commercial relationship or netting agreement are unexpectedly found to contain assets governed by foreign law. There are two ways of dealing with this. The first is to disregard the mistake and to cure any damage under appropriate compensation rules. The second solution is to declare the transfer of the relevant relationship or netting agreement void from the outset or from the moment when the mistake was discovered. The drawback here is that any dealings that had occurred in the meantime would have to be unravelled, which might be quite a complicated undertaking.

Comply with foreign-law transfer requirements

224. Another remedy would be to achieve compliance with the transfer requirements under the applicable foreign law. As shown by the scenarios analysed earlier, the most relevant foreign-law transfer requirement is consent or other action by the counterparty or a third party. A prominent remedy would therefore be to impose a duty on both transferor and transferee actively to seek that consent or the required action by the relevant person. For instance, according to the UK Banking Act, section 39, the 'transferor and the transferee must each take any necessary steps to ensure that the transfer is effective as a matter of foreign law (if it is not wholly effective by virtue of the property transfer instrument)'.[176] According to the German Banking Act, § 48i, the transferor

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[173] British Bankers' Association, Special Resolution Regime – BBA Response to the HM Treasury Consultation Document, p. 2; Allen & Overy, Special Resolution Regime: Safeguards for Partial Property Transfers, January 2009, p. 7: ‚carve out all netting arrangements involving foreign property'.

[174] Allen & Overy, ibid., p. 9.

[175] Mayer-Brown¸ The banking act - the new special resolution regime for dealing with failing banks, p. …; British Bankers' Association, ibid. It appears that this tool is not always available; for Germany: G. Bachmann, Das neue Restrukturierungsrecht der Kreditinstitute, Zeitschrift für Bankrecht und Bankwirtschaft, 2010, p. 459, 467.

[176] This formula potentially comprises more actions than just obtaining consent from a third party or having an action performed by it.

(alone) is bound to take such steps.[177] Both rules are unconditional and formulated in such a way as to be enforceable.

225. How far that enforceability would reach remains in doubt, however. First, *de facto*, the process of obtaining all relevant parties' consent or getting them to perform the action expected of them in relation to all contracts governed by foreign law seems ambitious to say the least, given the stress under which an ailing institution on the brink of meltdown and facing restructuring and/or winding-up would be labouring. The relevant positions involving a foreign law element would need to be identified first, and there would be considerable uncertainty in this respect. There might be many of these, and there would certainly be time pressure, as netting packages and collateral arrangements would stay separated for the time it took to complete the process. The difficulties were amply illustrated by the process of sorting out Lehman Brothers, a negative precedent in terms of the practicalities involved in such a situation.[178]

226. Second, *de iure*, the ailing institution, and the bridge institution in the case of the UK, is bound to obtain a *third party's* consent.[179] That third person is itself not subject to the relevant duty and enforceability is accordingly limited, not least because the applicable restructuring legislation cannot reach across the border and impose a duty to consent or to perform an act on foreign subjects. Neither, respecting the rules of private international law, can the order itself be regarded as substituting for the consent.[180]

227. Ultimately, the practicability of this type of rule will always depend on the co-operation of the foreign third party.

Transferor acting as caretaker

228. UK and German law recognise the problem just described and provide for an appropriate safeguard. Both systems include a caretaker rule to cover the – obvious – case of a time lag occurring between the moment when the transfer of unproblematic assets becomes effective and the – later – moment when the transfer of assets involving a foreign law element does likewise. Basically, under both regimes the transferor must administer any assets not transferred for the account and in the interests of the transferee, against reimbursement of expenses.[181]

229. It is the main function of such a caretaker rule to clarify the rights and duties of the ailing and bridge institutions as well as the degree of protection of the non-transferred assets for as long as the transfer remains imperfect.

230. In any event, such a rule would need to incorporate a number of elements, some but not all of which are already addressed in existing legislation:

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[177] The EU Commission is now consulting as to whether similar provisions should become European standard: EU Commission Bank Recovery and Resolution Working Document, January 2011, Section G8.

[178] Cf. H. Ekué, Lehman Brothers: contrepartie dans des opérations sur produits dérivés, R de Droit bancaire et financier, 5 (2009), [2.].

[179] Where the duty is also imposed on the bridge institution, as in the case of the UK, it must be noted that a bridge institution can theoretically also be a foreign entity, as explicitly recognised in Section 210(c)(9)(B) of the Dodd-Frank Act. So far, this case does not seem to be catered for in any other regime (thought history – Fortis/BNP – shows that the idea is not necessarily absurd) and the bridge institution would need to have comparable duties under its regulatory regime.

[180] I wonder whether that duty would actually work in all purely domestic cases. E.g., would the regulator's power to transfer assets override the mechanism protecting restricted registered shares? Where the third person's consent is deemed, by virtue of law, to be given or substituted by the regulatory transfer order itself, certain safeguards are overruled which are normally considered as being very strong. That might not work in all cases, in particular where lex societatis is affected or property rights are compromised (expropriation!).

[181] Cf. § 48i(2) German Banking Act; Section 39(4) and (5) UK Banking Act 2009.

- In the interim phase, the non-transferred assets need to be exempted from the ailing bank's estate, so as to shield them from the latter's insolvency (or winding-up or a similar procedure) which might occur within a very short time. The non-transferred assets are held for the benefit of the transferee and not available to the insolvency administrator for distribution among the general creditors. German law contains an express rule to that effect.[182]

- There needs to be a duty on the ailing bank (caretaker) to conserve the assets and administer them. A reasonable standard of care would need to be set, for example, the assets would need to be administered in a commercially reasonable manner, or in accordance with instructions given by the transferor.

- The aforementioned duty extends to new assets, rights and liabilities accruing to the caretaker from the assets under administration.

- There needs to be a rule addressing cost compensation.

- There needs to be a rule addressing liability in the event of deterioration or devaluation of the assets.

Re-unification of the bundle of financial contracts

231. Since the caretaking period may last some time, there needs to be a rule setting out the consequences of a termination event occurring in the sphere of the bridge institution at a time when the non-transferred assets are still legally attributed to the ailing institution (transferor and caretaker). As the bundle of financial contracts covered by the netting agreement is still separated at that time, there is no ready solution at hand.

232. As a matter of principle, the netting mechanism should be allowed to operate in this instance since a stay or ban would trigger considerable legal uncertainty vis-à-vis the entire concept of netting. That means that three possible approaches remain.

Netting over transferee's estate, exclusion of non-transferred assets

233. The first solution would be for the netting mechanism to operate on the principle of *exclusion* of the non-transferred assets, i.e. exclusively between the bridge institution and the counterparty. This would inevitably lead to a distorted net amount, primarily because non-transferred assets will often consist of collateral governed by foreign law. This collateral would now be unavailable for the calculation of mutual obligations. The distortion is therefore liable to be disproportionate.

234. Further, insofar as the assets are not included in the netting mechanism, they would remain in the estate of the transferor which is still acting as caretaker for the transferee. The latter would retain a claim that the assets be transferred. It seems unpractical to include that claim (or rather its value) into the calculation of the net amount. As the transferee retains this claim even if it falls insolvent, the situation would lead to preferential treatment of its creditors to the detriment of the original counterparty. That would be a highly unsatisfactory solution.

Netting over both estates

235. The second solution would be for the netting to *include* the non-transferred assets. The law could provide for the netting to extend to both the assets transferred to the bridge institution and

[182] Cf. § 48i(3) German Banking Act. It is not entirely clear whether the formula in Section 39(4) and (5) UK Banking Act 2009 ('transferor holds for the benefit of the transferee') is sufficiently clear to indicate that the assets are shielded from being included in the insolvent estate, e.g. whether the formula indicates the existence of a trust or similar.

any assets that had not been transferred, despite this *de iure* split between the transferor and the transferee. From the point of view of the two institutions, such a solution should not have any disadvantages, while the counterparty for its part would not suffer any losses since the netting mechanism would extend to the complete bundle of financial contracts. However, this solution is difficult to explain from the conceptual point of view since the netting agreement has been transferred to the transferee and technically does not cover the transferor. In traditional terms, one might speak of a lack of mutuality.

Re-transfer and re-unification

236. A third solution would consist in a re-transfer of the relevant assets, rights and liabilities, including the master and netting agreements which in a first step were effectively transferred to the bridge institution.[183] In this way, they would be re-united with the non-transferred assets that remained in the transferor's estate. Once re-united under the transferor's roof, termination and close-out would be possible. This solution is certainly difficult to achieve in operational terms, not least because of time pressure, but is nevertheless consistent from a legal point of view, since the bundle of financial contracts covered by the netting agreement would be reunited and mutuality between the parties restored.

237. Furthermore, it is not unlikely that the bridge institution would have continued its operations subsequent to the transfer (that is the purpose of having one in the first place), including doing business with the counterparty to the relevant netting agreement. What if, in the course of this subsequent business, new assets, rights and liabilities were to be included which again contained a foreign element? Re-transferability would probably be impaired and there would be no neat exit from that situation.

Compensation

238. As a further remedy, compensation rules are necessary, since a regulatory transfer is likely to impinge on the rights of some of the parties involved.

239. First, the ailing institution's rights in respect of its estate are overridden by the transfer order. As a consequence, there must be rules determining whether the ailing bank's estate is to receive compensation for the loss of the assets transferred to the bridge institution.[184] If compensation were payment actually due, there would need to be a valuation mechanism.

240. Second, the counterparty's rights might be violated if the regulatory transfer were to be imperfect. The availability of netting might be unclear, or the net amount might be distorted, to the detriment of the counterparty.

241. Third, the regulatory transfer order might violate third party rights.

– As far as general creditors of the ailing institution are concerned, their prospects of their receiving payment of any of their claims may be grim in that the transfer order will remove all viable, and valuable, assets to the bridge institution, since the ailing institution itself will in most cases be about to turn into a 'bad' bank. Such general creditors will receive compensation under a principle known in the UK as 'no creditor worse off'.[185] The obvious difficulty will be how to calculate the reference amount that the counterparty would have

[183] Cf. § 48j (new) German Banking Act and supra, p. 56.

[184] Cf. Sections 49 et seqq. UK Banking Act 2009; § 48(s)(2) (new) German Banking Act.

[185] Cf. Section 60(2) UK Banking Act 2009.

received in a hypothetical full-bank insolvency, since this is subject to a number of assumptions and guesswork.[186]

- There will be third parties other than the ailing institution's creditors whose rights might be violated by the transfer order, in particular holders of a security interest over assets which are transferred as being unencumbered to the bridge institution – these would need to be compensated in the same manner as described above.[187]

Result: failure to provide sufficient certainty by virtue of domestic remedies

242. In order to establish whether available domestic remedies are capable of removing the threats caused by imperfect transfers and inefficient moratoria, three questions would need to be considered.

Domestic measures unable to prevent or undo the legal separation

243. Three of the five domestic remedies described above are designed to deal with the separation of financial contracts bundled by a netting agreement:

- Rules that keep the bundle together are effective but hinder the result aimed for by the regulatory action since they render much of the ailing bank's estate non-transferable.

- Rules that seek compliance with foreign-law transfer requirements are effective in the domestic context but might be partly ineffective in keeping together or re-uniting a bundle of financial contracts covered by a netting agreement as soon as foreign law is involved. This is essentially due to the fact that there exists no legal means of forcing a party to take the action or give its consent required of it in respect of the transfer.

- Rules that re-unite the bundle after its separation are effective under ideal circumstances. However, an important drawback is that a re-transfer assumes that the relevant part of the bundle will remain unchanged after arriving in the sphere of the bridge institution. Often, however, that might not be the case: further dealings might take place in the meantime or (in the worst-case scenario) a termination event might occur in the sphere of the bridge institution while some of the financial contracts covered by the netting agreement were separated from the bundle.

244. It is probably fair to say that, as a result, these rules do not provide sufficient legal certainty as to the enforceability of netting agreements when foreign law becomes involved. However, for lack of a better solution so far, the existence of such rules is crucial.

Domestic measures unable to absorb damages caused by imperfect transfer

245. The second question is that of whether domestic law remedies would be capable of effectively absorbing the damage caused by separation of the netting bundle or a partially ineffective moratorium, from the moment foreign law becomes involved. The remaining two domestic remedies described above pursue this aim.

- The caretaker rule can partly resolve the problem caused by an imperfect transfer and delivers a legally coherent solution. However, the rule is only designed to serve over a

[186] HM Treasury, Special Resolution Regime: safeguards for partial property transfer, November 2008, paragraphs 1.41: 'The 'no creditor worse off' process requires the counterfactual calculation of the result of a whole-bank insolvency in which the dividend, if any, due to each creditor from the counterfactual insolvency estate of the bank would be calculated.' EU Commission Bank Recovery and Resolution Working Document, January 2011, Section G11 summarises some of the relevant criteria.

[187] Cf. Section 60(1) UK Banking Act 2009: third party compensation.

transitional period and loses its efficacy as soon as a termination event occurs in the sphere of the bridge institution.

- Compensation rules are able to cushion the economic damage suffered by the transferor and third parties. Exact compensation amounts are difficult to determine. Relief from such rules will only occur after a considerable lapse of time. By nature, they do *not* remove legal uncertainty in respect of the availability of netting.

Domestic measures unable to enforce a moratorium across jurisdictional borders

246. In so far as netting remains possible on the basis of a foreign-law-governed netting agreement, as described above, there seems to be *no* domestic remedy in place that addresses this question.

Conclusion

247. The overall impression is that domestic remedies are *unable* to guarantee sufficient legal certainty in respect of the proper enforceability of netting agreements as soon as cross-jurisdictional elements become involved.

V. Cross-jurisdictional solution

248. The obvious response to the domestic law's inability to provide sufficient legal certainty is to promote cross-border legal effects of regulatory measures in foreign jurisdictions. Such effects would need to occur in two directions.

249. First, domestic law and domestic authority are unable to produce an effect under foreign law and have no influence on foreign authorities or courts. Ideally, therefore, relevant regulatory measures should be 'given value' under foreign law and by foreign authorities and courts.[188]

250. Conversely, foreign law does not have immediate effects for domestically governed contracts, domestic authorities and courts. Therefore, domestic law and regulation would need to 'give value' to foreign regulatory powers on its territory as well.[189]

251. However, it will not be sufficient to cater exclusively for transfer orders and moratoria in an international context.

Cross-jurisdictional effects of transfer and moratorium

252. In the foregoing paragraphs, I have deliberately used the term 'giving value' to describe that regulatory measures should ideally have a cross-border effect. This terminological openness appears necessary for obvious reasons: immediate cross-border *legal* recognition of a binding nature is the hard-law alternative available at one end of the range of available mechanisms. At the other end of that range, much 'softer' approaches are conceivable.

253. However, when it comes to ensuring *legal certainty* as to the enforceability of netting agreements in the light of possible regulatory transfer and moratorium, there is only one coherent solution – *direct legal* cross-jurisdictional effect of transfer orders and regulatory moratoria. Only by attributing direct legal effect under both the domestic and foreign law will it be possible, with

[188] Cf. FDIC, Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions, US Federal Register Vol. 75 (2010), 64173, 64177: 'The key reforms involve recognition in the foreign legal and regulatory systems where the FDIC would control the company's assets and operations.'

[189] Cf. in relation to the Dodd-Frank Act: Cleary Gottlieb Steen & Hamilton, Comment on Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions, Letter to the FDIC, 18 January 2011, p. 2 et seq.

any certainty, to prevent financial contracts covered by a netting agreement from becoming separated or netting agreements from being operated in respect of only part of the financial contracts covered. The only alternative is not to transfer and not to impose a moratorium at all the moment foreign law elements of the kind described earlier become involved.

254. Which other solutions would be at hand?

- Authorities and courts should consider promoting the effect of foreign regulatory transfer and moratoria under their own legal framework.

- Authorities, acting on an appropriate domestic legal basis, have regard to a foreign regulatory act and decide whether to adopt a replicating or complementary domestic act to achieve effects under domestic law that are complementary to the foreign regulatory transfer or moratorium.

- Authorities, acting on an appropriate domestic legal basis, endorse a foreign regulatory act, thereby creating the identical legal effect in their territory.

255. All these measures are certainly better than nothing and are able to produce a legal effect – but they cannot produce legal *certainty* as it will never be possible to predict without the shadow of a doubt that the authority will actually take the necessary complementary action (simultaneously!) or that a court will actually consider the effect of the foreign regulatory action under its domestic insolvency law.

256. Without that certainty, legal opinions certifying that netting will be legally enforceable in a given jurisdiction – also in the event of foreign law being involved – will be difficult to obtain without a carve-out in respect of the possible exercise of the regulatory tools, thereby wiping out part of the function of netting as a recognised risk mitigation tool.

257. However, despite the fact that the necessity for direct legal cross-border effect is a *legal* one, the question does not belong to the sphere of private law. Rather, the decision of whether such a mechanism would be feasible is *policy*-driven. Regulators have to decide whether they are able to give up autonomy in exchange for mutual recognition of their own measures. Additionally, it is obvious that tax-payers' money is involved and would need to be protected. Therefore, it is up to the Basel Committee's CBRG, the EU Commission, the Financial Stability Board and other international regulatory fora to look into that question.

Compatible wider regulatory regime

258. If such cross-jurisdictional direct legal effect were to be agreed upon by regulatory policy makers, the primary tools (transfer order and moratorium) would have to be accompanied by the following:

Ancillary tools

259. First, cross-jurisdictional effectiveness should extend not to transfer and moratorium alone but also to certain ancillary tools. The EU Commission Working Document[190] proposes five ancillary tools as useful in the domestic context. These five proposals are:

- to transfer assets free from any encumbrance;

- to remove rights to acquire further shares;

[190] Cf. EU Commission Working Document, ibid. Section G6.

- to discontinue admission to stock exchange trading;
- to provide for the bridge institution to be treated as if it were the transferor for the purposes of any obligation, contracts, etc. previously entered into by the transferor;
- to require the ailing institution and bridge institution to co-operate.

260. This list may not be complete. The EU Document does not refer to any need for these rights to be extended to foreign jurisdictions as well. However, it would appear to make sense for the first two proposals listed to be extended across jurisdictional borders.

Cross-jurisdictional compensation

261. In so far as a regulatory transfer and/or moratorium produce effects across jurisdictions, the counterparty's or third parties' rights may be impaired under the foreign law, *cf. supra*. The damage will run parallel to that which occurs in the regulator's own jurisdiction in comparable circumstances. Therefore, parallel remedies are needed to cushion the damage on both sides of the jurisdictional border.

262. An international solution would need to address the following issues:

- first, it should determine whether the compensation schemes of one or the other jurisdiction apply;
- second, it should identify the mechanisms by means of which the cost of the compensation is allocated and to whom;
- third, it should establish what the legal protection, including the competent court, of foreign third parties would be.

Fall-back availability of remedies

263. There would need to be a fall-back mechanism covering assets, rights and liabilities governed by a (third) foreign law which does *not* recognise the legal effects of the transfer order. This corresponds to the current *status quo*.[191]

264. There are situations involving more than two jurisdictions (*cf.*, for example, 'Transfer of assets covered by a foreign netting agreement' *supra*, p. 54) in which two may recognise cross-jurisdictional legal effects but the third might not. If mechanisms such as the caretaker rule, or rules designed to keep the bundle of financial contracts complete, etc. (*cf. supra*) are not aligned between the two co-ordinated jurisdictions, their common framework might be jeopardised by the interference of the third law.

Compatible netting legislation

265. Any cross-border legal recognition of the effect of a regulatory transfer or moratorium would also require the netting legislation of the relevant countries to be compatible. It is obvious that netting should be generally recognised in all jurisdictions, including that of the transferee (if the transfer is made to a foreign transferee). Equally, the conflict-of-laws framework would need to be clear (*cf.* p. 32 *et seqq.*). Further, also in the context of bank-resolution regimes, there is the question of whether harmonisation or clarification of substantive law would be required.

[191] If the EU, for instance, were in the future to implement full cross-jurisdictional recognition of transfer orders and moratoria, fall-back mechanisms would only be needed for assets, rights and liabilities covered by the law of a non-European jurisdiction: cf. EU Commission Working Document, ibid., G13 in fine

Harmonising the understanding of netting and the basic legal mechanism protecting its enforceability

266. The first part of this report has shown[192] that there is a need to harmonise the basic mechanism of netting, notably as regards the definition of netting and the core mechanism protecting its enforceability in a party's insolvency. This necessity is confirmed from the perspective of cross-border bank resolution, as similar issues in relation to the conceptual characteristics of netting occur.

Example 16*:* Two countries decide that moratoria on netting imposed by their regulators should be mutually recognised across their respective laws. Country A's law prescribes (in order to achieve a moratorium-like effect) that the competent authority can decree that insolvency and other events be disregarded as termination events under netting agreements. Country B's netting legislation consists of a statutory netting clause which by operation of law terminates and accelerates the contracts covered by a netting agreement and transforms them into a single claim. The party in Country A enters a resolution proceeding and the authority issues the ban on netting described above. The party in Country B also falls insolvent. The competent court holds that statutory netting cannot be halted by the moratorium, as the statutory rule is not based on a contractually agreed termination event.

267. Further examples can be found. Against this background, it is fair to say that the general need to harmonise the conceptual characteristics of netting can also be identified in the context of bank resolution. Effective bank resolution regimes require a certain degree of harmonisation of the conceptual characteristics of netting.

Harmonising lists of eligible parties, eligible financial contracts and formalities

268. The 1st Part concluded[193] that the issues regarding lists of eligible parties, lists of eligible financial contracts and formalities would need to be harmonised in order to make possible cross-jurisdictional legal succession, in particular in the context of a merger. This finding is confirmed in the context of bank resolution.

Example 17 *(Eligible contracts): Ailing Bank is in Country A., Solvent Bank in Country B. The mutual netting agreement including all covered financial contracts is governed by A-law. A-law does not restrict the list of eligible financial contracts. Ailing Bank is on the brink of insolvency and the competent authority transfers its business, including the relevant netting agreement, to Acquirer Bank in Country C. The insolvency law of Country C recognises netting. However, the list of eligible transactions is heavily restricted. Later, Acquirer Bank falls insolvent. The insolvency court in Country C rules that netting cannot occur as a considerable number of non-eligible contracts are included in the netting agreement.*

Example 18 *(Eligible contracts – inclusion of collateral): As before. The law of Country C requires the netting to be stipulated in connection with a collateral arrangement. However, there is no collateral included. The competent authority cannot transfer the business without deteriorating the exposure of the counterparty Solvent Bank.*

Example 19 *(Eligible party): Ailing Bank is in Country A. Its counterparty Solvent Bank and the affiliate Solvent-SPV, which does not have a banking license, are in Country B. When Ailing Bank risk falling insolvent, the competent authority intends to transfer its business to Acquirer Bank in Country C. C-law is considered to be 'netting friendly'. However, the competent authority realises that it ought not to transfer any netting agreement which includes Solvent-SPV as counterparty, since C-law allows netting only for banks.*

Example 20 *(Formalities): The parties are in jurisdictions A and B which are both regarded as 'netting friendly'. They have concluded a netting agreement. In jurisdiction B, in order to be enforceable in the event of insolvency, the netting agreement and the covered financial contracts need to be registered (name of the parties, category of transaction, transaction number). The party in Jurisdiction A enters a*

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192 Cf. p. 40, supra.

193 Cf. p. 41, supra.

resolution proceeding and its assets, rights and liabilities are transferred to a bridge bank, also in jurisdiction A. The entry in the trade repository in jurisdiction B is not changed. The party in jurisdiction B falls insolvent. The court refuses to uphold the enforceability of the netting agreement, as the registration condition was not complied with.

269. These examples show that effective bank resolution tools are inextricably linked to a legal framework for netting that is sound and compatible across jurisdictions. Putting the findings of the preceding paragraphs together, it becomes clear that a piecemeal approach would be unable to deliver a framework capable of guaranteeing (a) that resolution tools would not render netting unenforceable, and (b) that the operation of the netting mechanism would not impair the effectiveness of resolution tools. The need for harmonisation is therefore comprehensive.

VI. Need for harmonisation in respect of netting and bank resolution powers

270. Two of the three imperatives flowing from the above findings are addressed to the regulatory community and fall outside the scope of this study. [194] The third imperative, however, reiterates and endorses the findings of the 1st Part and relates back to issues involving the enforceability of netting in the context of general insolvency and commercial law.

Imperative 2-A (regulatory): Harmonise cross-jurisdictional effects of regulatory transfers and moratoria

271. In order to protect the full enforceability of netting agreements in a cross-jurisdictional context, regulatory transfers and moratoria would need to have cross-jurisdictional effects.

Imperative 2-B (regulatory): Harmonise the wider regulatory regime of regulatory transfers and moratoria

272. In the event of cross-jurisdictional effect being given to transfers and moratoria, a number of ancillary tools, such as re-transfer, would also need to function in a cross-border manner.

Imperative 2-C: Harmonise netting legislation

273. Effective cross-border regulatory transfers and moratoria require that the rules guaranteeing the enforceability of netting are harmonised. Otherwise, (i) transfers could disrupt netting, and/or (ii) the application of netting laws could undermine the effectiveness of transfers and moratoria. The existence of bank resolution tools therefore requires the legal framework for netting to be harmonised along the principles outlined in Imperatives 1-A, 1-B, 1-C and 1-D (*supra,* p. 37).

[194] Cf. EU Commission Bank Recovery and Resolution Working Document, January 2011, Section G13.

3rd Part: How to harmonise netting legislation

274. On the strength of the findings of the 1st and 2nd Parts, this report submits that legal soundness calls for the harmonisation of domestic law governing the enforceability of netting agreements. More precisely, legal certainty calls for:

- harmonisation of the understanding of netting and the mechanism protecting its enforceability in the insolvency of one of the parties;

- clarification/harmonisation of the lists of eligible parties, eligible contracts and of formalities; and,

- a clear and compatible conflict-of-laws regime for netting.

275. This 3rd Part seeks to give some guidance as to how the harmonisation of these areas could be achieved, drawing on the analysis in the 1st and 2nd Parts. It addresses two main strands, to wit, the *scope* of international harmonisation and its *form*.

276. This Part does not address the issue of whether or not countries should adopt netting-friendly laws. The regulatory community has issued a clear recommendation to that effect[195]. Hence, any future international instrument setting a harmonised standard would address, on the one hand:

- jurisdictions that already have netting-friendly legislation and plan to increase legal certainty by harmonising that legislation with the laws of other financial markets,

  or, on the other hand,

- jurisdictions in the process of introducing netting legislation that seek guidance as to how to shape their laws, in order safely to connect them to those of its partner markets.

1. Scope

277. An international instrument would need to cover – at least – the following issues:

Definition of close-out netting[196]

278. An international instrument addressing the enforceability of netting would have to agree on a clear definition, not least to avoid disparate interpretation of netting as this would endanger a common understanding and thus undermine legal certainty. The definition of netting should refer to a mechanism under which all or some of the following elements occur:

- the netting mechanism is triggered by the occurrence (often not automatically but requiring notice by the other party) of a termination event, which can be defined under the netting agreement;

- termination of unsettled financial contracts; however, the netting agreement itself should not be terminated, so that the netting mechanism can perform properly;

- acceleration of obligations under these contracts so as to render them immediately due;

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[195] Cf. p. 21 et seqq.; Basel Committee CBRG Report, Recommendation 8, p. 36 et seq.

[196] Cf. pp. 15, 31 and 40, supra.

- valuation of the terminated contracts (other than payment obligations but extending to foreign exchange);

- calculation of a net amount in a single currency reflecting the value of the terminated financial contracts as well as the mutual rights and obligations that were already due.

279. Article 31(3)(j) of the Geneva Securities Convention (and very similarly, Article 2 paragraph 1 of the EU Financial Collateral Directive[197]) combines these elements to form a functional definition of netting and delivers a blueprint for a possible future definition for use in a general instrument on netting:

280. ‘Close-out netting provision’ means a provision [...] under which, on the occurrence of an enforcement event, either or both of the following occur, or may at the election of [the other party] occur, whether through the operation of netting or set-off or otherwise:

281. (i) the respective obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount;

282. (ii) account is taken of what is due from each party to the other in relation to such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.’

Form of the agreement; formalities[198]

283. Despite the fact that netting agreements are *usually* part of standardised legal documentation (‘master agreements’) provided by financial market associations (*cf. supra*), the netting agreement itself is in principle a contract privately negotiated on the grounds of freedom of contract. Not much would therefore need to be said in an international instrument as regards the characteristics of the 'agreement'.

Evidentiary requirements

284. As netting agreements are supposed to be valid in the event of insolvency of one of the parties, consideration needs to be given to evidentiary requirements. Those might exist in relation to (i) the netting agreement, and (ii) the financial contracts covered by it.

285. As regards the netting agreement, in a cross-border context requirements such as notarisation, registration or filing with a public register risk being mishandled since they are not harmonised. Mishandling any filing or similar procedure may result in instant invalidity of the netting agreement on formal grounds even where the parties unanimously agree with its terms. Where such a defect is not detected until the moment at which one of the parties defaults, the resulting damage is potentially disastrous.

286. An international instrument should therefore settle on netting agreements being evidenced in writing or in any legally equivalent manner, this latter element being important so as to include not only e-mail but also electronic messaging applied within settlement systems.

287. The same applies in principle to the financial contracts included in the netting agreement. However, special attention should be paid to the following: many netting agreements are concluded to cover all kinds of derivatives contracts. In attempting to render the derivatives market more

[197] Cf. p. 28, supra.

[198] Cf. p. 33, supra.

transparent, many jurisdictions have recently introduced or are about to introduce a duty to register certain types of standardised derivatives with a register or trade repository. This act of registration is required for prudential/supervisory purposes. It should not be made a condition for a financial contract's capability of being included in a netting agreement, since the motivation is not the same. Additionally, the legal consequences are different: non-registration as such in the supervisory context does not produce risk but will merely entail fines or similar sanctions. Non-registration where registration is a prerequisite for the enforceability of the netting agreement would actually create a risk, since it would endanger enforceability without the parties (and the regulator, too) realising this.

Standard documentation and customised agreements

288. Another issue is the tension between netting agreements contained in a standardised master agreement and agreements between parties that wish to individualise their relationship. If jurisdictions protect the enforceability of netting agreements only if they are included in a standard document, individual amendments would imperil enforceability.

289. However, the relationship between two financial institutions can be very sophisticated indeed, entailing a need to individualise and thus change the master agreement to some degree. It is impossible to harmonise the extent to which such changes should be admissible, simply because there are too many different, individual situations. Hence, the concept of only protecting the enforceability of netting agreements that are part of standard documentation is unworkable in a cross-jurisdictional context.

Umbrella-agreements

290. The common practice of tying together several master agreements between identical parties by an umbrella-agreement (either in the form of 'master-master agreement' or 'cross-agreement bridge') deserves special attention, so as to remove any uncertainty as to the validity of such umbrella agreements. This is particularly important since an umbrella agreement might also alter the terms of the bundled netting agreements.

291. From a contractual law principles point of view, this practice would not seem to give rise to any particular problems. Yet it would probably make sense to include a clarification regarding umbrella agreements since, while their mechanism does result in a computation of the amounts resulting from the operation of the netting agreements they cover, they do not net the financial contracts themselves. In other words, an umbrella agreement enables further netting to occur after netting has taken place under each individual netting agreement.

The mechanism protecting enforceability[199]

292. Enhancing the enforceability of netting agreements is done primarily with the case of insolvency of the counterparty in mind. However, while insolvency netting is the most prevalent situation, it should be made clear that netting agreements should also be enforceable outside an insolvency setting.

293. A first possible approach to harmonising the substantive law would consist in specifying, on a case-by-case basis, which legal rules (insolvency procedural and others) should not be allowed to prejudice the enforceability of netting agreements. The obvious advantage of this approach would be that all intended consequences, i.e., which general legal rules would be overridden by the enforceability of netting agreements, would be written into the law in black and white.

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[199] Cf. supra, p. 32 et seq.

294. Another approach would be to include in the substantive law a general provision to the effect that the enforceability of netting agreements is not precluded by any rule of the law, including insolvency law. The clear advantage of this approach would be that there would be no risk of failing to list one or other problematic rule. It is this approach that was adopted in Article 33, paragraphs 1 and 3 of the Geneva Securities Convention (and the similar provision in the EU Financial Collateral Directive):

> 'at the occurrence of an enforcement event […] a close-out netting provision may be operated'; and
>
> '[…] a close out provision may be operated […] notwithstanding the commencement or continuation of an insolvency proceeding in relation to the collateral provider or the collateral taker.'

295. Consideration might be given to the idea that an international instrument focusing solely on netting might benefit from achieving both objectives (illustration by enumeration to facilitate a common understanding of potentially problematic situations, based on a general rule guaranteeing comprehensiveness).

296. Insofar as the term 'insolvency proceeding' needs to be specified, an international instrument should opt for a broad definition. Given the vicinity of the subject-matter, the definition of insolvency agreed upon in the Geneva Securities Convention would appear to be a good starting point.

List of eligible financial contracts

297. Here, basically two questions arise: first, which types of financial contract should be covered? and second, which technique should be employed in defining this group in an international instrument?

Types of contract

298. The need to make certain of the enforceability of netting arrangements is probably most urgently felt in relation to repurchase agreements and derivatives. The background to this is that, flowing from the logic inherent in such instruments, the credit risk associated with such contracts and hence, the potential exposure in the event of default of the counterparty, may be particularly high. However, derivatives and repos are not the only financial contracts where the reduction of counterparty credit risk makes sense. There are several other types of financial contract that are characterised by the phenomenon of life-threatening gross exposure and much smaller net exposure that could be absorbed in the event of counterparty failure.

299. To counter this, it would be advisable to opt for the inclusion of a wide range of financial contracts, in particular:

- derivatives;
- sale, repurchase and lending agreements relating to securities or commodities;
- agreements providing collateral or security;
- agreements regarding the maintenance of financial instruments in accounts for the counterparty, on clearing and settlement of financial instruments or on safekeeping of physical certificates.

300. It is particularly important to give thought to the possibility of including collateral arrangements in the range of eligible financial contracts.[200] If these were included, the law would allow collateral provided in connection with a netting agreement itself to be included in the close-out mechanism. Otherwise, the underlying financial contracts would be subject to netting and result in a single payment obligation, whereas the collateral provided in connection with the underlying contracts (which may potentially represent huge amounts) would need to be wound up separately. However, the intention is not to change the requirements for validity and enforceability of collateral interests. Therefore, the possibility of including related collateral arrangements in the netting agreement would apply only to those collateral interests established in accordance with the applicable law.

How to define the list of eligible contracts

301. The second issue relates to the technical definition of the material scope of eligible contracts. Although there is a common understanding in the financial market regarding the content of the various financial contracts listed above, the legal terminology in this area is heterogeneous. An international instrument would therefore need to take a consistent approach in setting out the material scope of eligible contracts – uncertainty regarding the scope could easily translate into uncertainty as to whether the netting agreement was enforceable or not.

302. There are basically three options for defining the material scope as covering all financial contracts.

- The first option is a generic clause combining the description of the categories of agreement with a description of the substrate of the agreement. Categories would include in particular derivatives (options, futures, swaps, forwards and suchlike), sale, repurchase, lending, provision of collateral, and acceptance for clearing, settlement or safekeeping. The substrate of the agreement commonly relates to the categories of foreign currency, securities (shares, bonds), commodities including metals, indices, prices (emission allowances, freight rates, etc.), and other elements (credit default, weather, etc.).

- The second option would consist in setting out a comprehensive list of all financial contracts that are currently in common use in the financial markets.

- The third option would be to refer the task of defining which types of financial contract are covered to the national competent authorities such as central banks and supervisory authorities.

303. Any of these three options entails advantages and disadvantages in terms of certainty of interpretation, consistency of coverage and flexibility to accommodate new market developments. While the third option probably offers the best results in terms of certainty of material scope, it is also liable to produce a very high degree of inconsistency since the different national authorities may take a narrower or wider view of what the scope is, so that the global view of the material scope may end up resembling a patchwork. The second option would provide for a consistent scope, but the terms employed in the definitions, which are basically market terms, would be open to some residual margin of interpretation, and as netting agreements are privately negotiated, the definitions in a list provided by market associations are likewise open to amendment. Furthermore, a fixed list would be unable to accommodate new market developments. This last problem can only be countered by providing an opening clause in addition to the list of financial contracts. Such an

200 Articles 2(1)(n) and 7 of the EU Financial Collateral Directive contain a specific rule protecting (only) collateral provided on the basis of a title transfer. Cash or securities provided under such a title-transfer collateral agreement can be included in the netting mechanism together with the secured claims.

opening clause would in substance correspond to a generic description of the material scope, which is the first option.

304. Ultimately, therefore, a generic definition is probably the most appropriate solution, and any detailed list of known financial contracts should rather figure in an explanatory text to accompany the instrument. In developing that definition, great attention will have to be paid to neutrality of language and functionality of concepts, since market terms such as, for example, 'forward' or 'spot' might be interpreted differently in different jurisdictions.

List of eligible parties[201]

305. An international instrument cannot reflect national policy considerations in its personal scope. First, there are too many reasons for restricting the scope, and policy considerations valid in one jurisdiction might not make much sense in others.

306. Inconsistent handling of the personal scope of an international instrument would cut away much of the legal certainty it seeks to achieve. One of the main drivers for harmonisation of netting legislation is its preventive effect in terms of the systemic implications of market participants' insolvency. While it is true that the systemic argument is most obvious with respect to financial institutions, it is not conceptually confined to this category of market participant. Other types of party that are associated to a greater (e.g. insurance companies – *cf.* AIG 2008) or lesser (e.g. carmakers – *cf*. General Motors 2008) extent with financial institutions can spark similar effects through the global financial architecture if they fall insolvent and netting is not available.

307. An international instrument, by contrast, should, as a first step, settle on the principle of being applicable to all types of party, except consumers. Where jurisdictions feel a need to exclude certain parties from this area of the financial market, a first consideration should be whether the policy is regulatory in nature (e.g., certain instruments should be restricted to certain market participants) or whether it is actually founded in the environment of legal enforceability of netting as a risk mitigation mechanism. Where the policy actually has its roots in the risk mitigation environment, mechanisms would need to be developed to allow for making declarations in this respect or to opt-out of certain categories. A categorisation of institutions would be helpful in this respect.

Conflict-of-laws approach[202]

308. The main difficulty of existing conflict-of-laws regimes lies in the fact that it is often not clear whether there are distinct rules for set-off, on the one hand, and for netting, on the other hand. An international instrument would need to clarify this dichotomy.

2. Approach and form of international harmonisation

309. Developing an international instrument on the legal framework for netting would probably require a mixed approach, with the final result being achieved in two steps.

310. The notion of a mixed approach is used here to refer to the question of whether a binding (international Convention) or non-binding (model law, principles) instrument should be envisaged. The first impression suggests that work envisaging both types of instrument would be able to unlock the distinct advantages of both the binding and the non-binding approach, in respect of different areas of the subject-matter. At the same time, certain drawbacks could be avoided, in particular that of encroaching upon fundamental policy decisions taken by the various jurisdictions.

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[201] Cf. supra, p. 35 et seq.

[202] Cf. supra, p. 37 et seqq.

A non-binding international instrument

311. A non-binding international instrument, such as, in particular, principles or a model law, would be able to provide a detailed foundation of how cross-jurisdictional effects could be achieved. Such an instrument would set a standard developed at the international level without being directly binding.

- Work on a non-binding instrument would provide an opportunity to make a very detailed contribution as to the substance in a first step, promoting in-depth understanding of the relevant issues in a wide range of markets and jurisdictions.

- A non-binding instrument could serve as a benchmark against which fellow markets and market participants can assess the degree to which cross-jurisdictional consistency of regulatory transfers could be achieved.

- A non-binding instrument could serve as a reference in the context of regulatory co-operation.

- A non-binding instrument could serve as a means to explore the need for and the feasibility of a more focused binding international instrument.

A binding international instrument

312. The legal difficulties attending the creation of a binding instrument are evident. However, there might be appetite amongst heavily interconnected financial markets to enter into a binding cross-jurisdictional framework on isolated issues and where required for reasons of legal certainty.

- A binding instrument would be able to provide for an integrated cross-jurisdictional mechanism ensuring the highest degree of legal certainty.

- The potential drawbacks of a binding instrument for individual markets' own jurisdictions might be acceptable in so far as jurisdictions have already engaged in some policy wrangling in the past, when netting legislation was first introduced.

- A binding instrument makes the more sense the more markets are interconnected, as they all share the same advantages and drawbacks flowing from a sound or unsound legal framework, respectively.

- In recent years, interconnected markets have aligned their regulatory architecture and bank-insolvency mechanisms. These structures would be complemented by a binding framework for netting, thus facilitating the regulators' and courts' common task. The EU Commission, in its January 2011 consultation paper[203], proposes that regulatory transfer orders of the competent authority of an EU Member State be given legal effect in respect of assets, rights and liabilities governed by the law of another EU Member State. It would be difficult to create strong, common regulatory tools if they were to be hampered by diverging laws for netting agreements and insolvency.

The two-steps approach

313. Making a distinction between issues that may be usefully addressed in a Convention and issues better suited to regulation in the form of principles or a model law in itself already requires a certain degree of common understanding. Moreover, the private law issues involved in agreeing on any new regulatory powers need to be explored further, in parallel with, and to some extent following, the evolution of the regulatory approach itself.

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[203] EU Commission Bank Recovery and Resolution Working Document, January 2011, Section G13.

314. As a consequence, under a two-step approach, work should start on a non-binding instrument, i.e. principles or a model-law, setting out all the material aspects. If it were subsequently to be deemed necessary, a second phase could follow with work undertaken on a binding instrument dealing with certain crucial, isolated aspects that require binding harmonisation in the interests of cross-jurisdictional legal certainty.

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