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**UNIDROIT Committee of governmental experts  
on the enforceability of close-out netting  
provisions  
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**Draft Principles regarding the  
enforceability of close-out netting provisions**

**COMMENTS**

*(submitted by Organisations)*

**INTRODUCTION**

Subsequently to the comments (C.G.E./Netting/2/W.P. 7) on the text of the UNIDROIT Draft Principles regarding the enforceability of close-out netting provisions (C.G.E./Netting/2/W.P. 2) and on a joint proposal submitted by the Governments of France, the United Kingdom and the United States of America concerning the principles on eligible parties and obligations (C.G.E./Netting/2/W.P. 4) for consideration by the Committee of Governmental Experts on the enforceability of close-out netting provisions at its second session from 4 to 8 March 2013, the UNIDROIT Secretariat received comments from the World Bank. These comments are reproduced hereunder.

**COMMENTS SUBMITTED BY ORGANISATIONS**

***World Bank***

**Comments on Draft Principles regarding the enforceability of close-out netting provisions (December 2012) (“Draft Principles”)**

1. We support the development of a set of internationally recognized principles on close-out netting. The current draft satisfactorily addresses many of the concerns discussed in connection with the previous draft principles (C.G.E./Netting/1/W.P.6). However, there remain a few concerns about the scope of the Draft Principles, their practical consequences and their policy justifications. Set out below are our key concerns.<sup>1</sup>

2. As a general matter, the enforceability of set-off in insolvency is subject to various restrictions (e.g., stay) in many jurisdictions with the policy purposes of (i) helping ensure, through

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<sup>1</sup> In order to make this a self-standing document and to minimize cross-references for ease of reading, we will reiterate our previous comments where appropriate.

the collective action mechanism of formal insolvency proceedings, that the relevant interests of stakeholders can be addressed in an orderly fashion, (ii) allowing a framework within which a determination could be made relating to the relative merits of rehabilitation/restructuring vs. liquidation. Close-out netting, properly understood, is a process that involves and produces the economic equivalent of set-off for a specified class of contracts.

3. We concur with the goal of the Draft Principles in defining an insolvency safe harbor for close-out netting provisions in financial contracts such that they may be enforced free of insolvency limitations. The consequences of such safe harbor in the event of insolvency or default of a counterparty include the following:

(a) To the extent of the debt owed by the non-defaulting party to the defaulting party, the former is able to obtain full recovery of the debt owed to it. This has the effect, in the context of insolvency, of putting the non-defaulting party ahead of the defaulting party's general unsecured creditors, preferential creditors,<sup>2</sup> and secured creditors.<sup>3</sup>

(b) Assets of the defaulting party that are subject to close out netting are therefore unavailable to assist in the defaulting party's restructuring or resolution.

4. In these circumstances, the parameters of the safe harbor for close-out netting should be clear and capable of cogent justification. Any ambiguity over the scope of the safe harbor set out in the Draft Principles or their justification could have unintended consequences on the operation of general insolvency law principles and policies as applied to entities or persons other than financial institutions. For this reason, we believe that the intended scope and rationale of the proposed safe harbor in the Draft Principles should be carefully defined so that national legislatures considering the enactment of netting-friendly legislation might be better positioned to make informed policy choices regarding the breadth of the concepts of 'eligible parties' and 'eligible obligations'.

5. Moreover, if netting-friendly legislation were enacted without the national legislature being clear about its scope and rationale, it would risk presenting interpretation problems to the court. There is a risk that any such interpretative ambiguity and the resulting legal uncertainty might be exploited by practitioners, thereby exposing the safe harbor to abusive or unintended use.

### **Executive summary**

6. The scope of the Draft Principles merits further clarity in order to better guide policy makers considering the enactment of netting-friendly legislation. In particular:

(a) Clarifying the distinction between close-out netting and set-off is important to defining the intended scope of the Draft Principles. We suggest that the functional definition of close-out netting be supplemented with a statement of the key elements of close-out netting, so that it is clear that pure contractual set-off generally falls outside the functional definition, except perhaps that one may have a contractual set-off of sums arising only from a close-out netting process (e.g., set-off effected by a master-master agreement).

(b) We support the joint proposal by the representatives from France, UK and US ("Joint Proposal") regarding the scope of eligible parties and eligible obligations. We believe that conforming changes elsewhere in the Draft Principles may need to be made so that the unique and important policy justifications for conferring special insolvency treatment on close-out netting are properly described.

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<sup>2</sup> Where, as is frequently the case, the insolvent estate is unable to discharge preferential debts (e.g. employees' accrued emoluments) in full.

<sup>3</sup> Where the relevant insolvency law imposes a stay on security enforcement and/or subordinates certain type security interest (e.g. floating charge) to certain claims in insolvency.

(c) The justifications for conferring safe harbor on close-out netting should be strengthened to focus on systemic risk, as these are already implicit in the Joint Proposal.

7. The protection against 'cherry picking' of eligible obligations appears to conflate the close-out netting process with the enforceability of the underlying obligations that may be subject to close-out netting. We suggest the deletion of Principle 7(1)(b).

8. The conflict of laws analysis, in allowing the governing law of a close-out netting clause to determine the scope of transactions entitled to enforcement in national courts, may lead to an unworkable result and may risk undermining the policy choices made by national legislatures. We suggest the deletion of Principle 9(2).

## **Principles 1 and 2**

9. Para 2 states that "close-out netting ... is *functionally and conceptually different from traditional set-off*" (emphasis added). We believe that this may overstate the distinction between close-out netting and set-off, and that such a categorical distinction appears inconsistent with other statements in the draft.

### *Set-off and close-out netting properly understood*

10. It is true that close-out netting involves a number of steps, such as acceleration and termination of contractual obligations followed by valuation, that are not necessary elements of set-off. But the final step of close-out netting to produce a net amount is essentially a set-off process, as confirmed by cases in different jurisdictions: *Revenue and Customs Commissioners v Enron Europe* [2006] EWHC 824 (Ch); [2006] STC 1339 at [20]; *Re Opes Prime Stockbroking* [2008] FCA 1425 at [3].

11. Further, the received international understanding is that set-off is an element of the close-out netting process:

"Close-out netting' embraces two steps: firstly, termination of all open contracts as a result of the commencement of insolvency proceedings (close-out); secondly, the *set-off* of all obligations arising out of the closed out transactions on an aggregate basis (netting)".<sup>4</sup>

### *Internal consistency*

12. The question of consistency arises in at least three places in the draft:

(a) Para 31 states that the close-out netting process of transactions/value aggregation "is *functionally the same result as the outcome of classical set-off* of all valued and payable obligations" (emphasis added).

(b) Para 19 states that the scope of the Draft Principles covers netting provisions in master-master agreements. Netting provisions in master-master agreements are merely contractual set-off provisions. Imagine a master-master netting agreement between A and B that requires a netting of all close-out sums arising from (i) stock lending transactions governed by a master stock lending agreement and (ii) repurchase transactions governed by a master repurchase agreement. All that the master-master netting agreement does is a cross-product netting of the fixed payable sums arrived at by the close-out mechanisms under the master stock lending agreement and the master repurchase agreement. Such cross-product netting is common, and is merely a contractual set-off.

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<sup>4</sup> UNCITRAL Legislative Guide on Insolvency Law (2004), para 210 (emphasis added).

(c) The discussion in para 71 in respect of the application of the Draft Principles to loans and deposits suggests that the Draft Principles are intended to cover mere contractual set-off.

13. In addition, the definition of “close-out netting provision” is merely a description in functional terms by reference to a result. Such functional, outcome-based definition would capture a pure contractual set-off provision, e.g., section 6(f) of the 2002 ISDA Master Agreement and para 11.8 of the 2010 Global Master Securities Lending Agreement which are not close-out netting provisions: *Lehman Brothers Commodity Services v Credit Agricole Corporate and Investment Bank* [2011] EWHC 1390 (Comm); [2012] 1 All ER (Comm) 254.<sup>5</sup>

14. Our concern is that the document’s internal inconsistency creates ambiguity in the scope of the Draft Principles: to what extent are these intended to address contractual set-off provisions as a general matter? Such ambiguity is heightened by the fact that “close-out netting is a new concept as yet not properly addressed in many jurisdictions, thereby forcing the courts to seek analogies to deal with this new matter” (para 91). The ambiguity in turn risks confusing the justifications for the Draft Principles (see also the discussion on Principle 4 below), and confusing the intended audience of the Draft Principles. The confusion becomes all the more palpable when considering the guidance preferred by the UNCITRAL Legislative Guide on Insolvency Law (2004) on the concept of close-out netting mentioned above, namely “‘Close-out netting’ embraces two steps: firstly, termination of all open contracts as a result of the commencement of insolvency proceedings (close-out); secondly, the *set-off* of all obligations arising out of the closed out transactions on an aggregate basis (netting)”.<sup>6</sup>

15. Accordingly, avoiding ambiguity in the scope of the Draft Principles is crucial. If the Draft Principles are to focus on close-out netting, we suggest replacing (or supplementing) the functional definition of close-out netting with a statement of the key elements of close-out netting, namely the happening of the following upon a specified event: (i) an automatic or discretionary termination of the relevant contractual obligations; (ii) the calculation of the termination values of the obligations; and (iii) the netting of the termination values so that only a net cash amount becomes payable.<sup>7</sup> If appropriate, the definition may further provide that contractual set-off is covered to the extent that it relates to a set-off of sums arising only from a close-out netting process (e.g. set-off effected by a master-master agreement).

16. Alternatively, if the Draft Principles are indeed to cover pure contractual set-off generally, there should be a clear statement to that effect. The justifications for conferring special treatment on the beneficiaries of set-off would then need to be explained and the significant policy implications to general insolvency law would also need to be clearly identified. The potentially adverse effects of a safe harbor reaching pure contractual set-off (in situation where important concerns relating to financial stability are not at issue) would also need to be considered.

### **Principles 3 and 4**

17. As we understand the Joint Proposal, the rationale of preventing systemic risk in the financial sector would be the motivating principle underlying the Draft Principles. We agree with this approach. We believe, therefore, that the Draft Principles would provide better guidance if other parts of the Draft were conformed to reflect this rationale.

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<sup>5</sup> ISDA has also received legal opinion confirming that section 6(f) of the 2002 ISDA Master Agreement is merely a set-off provision, not close-out netting.

<sup>6</sup> UNCITRAL Legislative Guide on Insolvency Law (2004), para 210 (emphasis added).

<sup>7</sup> Cf. Section 5 of the Australian Payment Systems and Netting Act 1998.

18. "Key considerations" are designed to help national legislatures as to the choices they would like to make regarding the scope of eligible parties and eligible obligations. In addition to systemic risk, two other considerations are mentioned, namely "Rapid changes of value" and "Single relationship". If the rationale for the creation of a safe harbor through the Draft Principles is to enable jurisdictions to better to address systemic risk, then it should be clarified that these two criteria (rapid changes of value and single relationship) are necessary additional criteria rather than separate rationales for the applicability of the safe harbor.

19. As we believe the better approach would be that the Draft Principles specifically focus on close out netting (rather purporting to cover pure contractual set-off) the reference to "Rapid changes of value" appears appropriate. Note, however, that the "rapid changes of value" justification would not apply to a master-master netting agreement which provides for netting between *fixed* close-out sums established under other master agreements (see the discussion in para 12(a) above). Depending on the scope that is ultimately agreed upon for the Draft Principles, the reference to "Rapid changes of value" may need to be appropriately qualified.

20. As regards "Single relationship", it is true that "it is more efficient for parties to monitor and manage their mutual risk exposure on the basis of an overall assessment of all contracts outstanding between them." But if this were an independent justification for "special treatment of the non-defaulting party in relation to the insolvent's general creditors", logic would compel the widest possible range of eligible parties and eligible obligations, not just those expressly envisaged in the Joint Proposal. We therefore suggest clarifying, under "Key considerations, that the 'Single relationship' justification is an additional necessary criterion for the application of the Draft Principles".

21. As "systemic risk" is the most relevant justification in this context, we also observe that "counterparty risk" should also be referenced as an additional criterion (rather than an independent justification) and para 65 should be amended accordingly. If "counterparty risk" per se were an independent justification for "special treatment of the non-defaulting party in relation to the insolvent's general creditors", logic would compel the widest possible range of eligible parties and eligible obligations, not just those expressly envisaged in the Joint Proposal.

## **Principle 7**

22. Principle 7(1)(b) regarding 'cherry picking' appears to detract from the position apparently agreed to during the October 2012 session that the Draft Principles would leave to each jurisdiction the question of the validity or enforceability of the transaction (including treatment of contracts during the twilight period), and appears hard to justify in policy terms.

23. Principle 7(1)(b)'s predecessor is Principle 7(c)(i) in these terms: "If an insolvency proceeding in relation to one of the parties has been commenced, the insolvency administrator or court should not be allowed to demand from the other party performance on only some of the obligations covered by the close-out netting provision, while repudiating the remaining obligations."

24. During the October session (and in written comments), the concern was raised that the effect of Principle 7(c)(i) appeared to be that so long as a contract was covered by a set-off clause, that contract would not be susceptible to rejection or disclaimer by an insolvency representative, even though the contract would otherwise be susceptible to rejection or disclaimer under general insolvency law. However, the consensus view at the meeting appeared to be that that this would be a misreading of Principle 7(c)(i) and that a contract which was susceptible to rejection or disclaimer under general insolvency law would remain so susceptible despite it being covered by a set-off clause. Hence para 71 of Secretariat report (C.G.E./Netting/1/Report).

25. However, the effect of Principle 7(1)(b), as currently drafted, is that a contract that is otherwise susceptible to rejection or disclaimer by an insolvency representative (thus not enforceable against an insolvency representative) under general insolvency law would become immune from rejection or disclaimer (thus enforceable against an insolvency representative). This appears to directly contradict the understanding set out in para 71 of Secretariat report (C.G.E./Netting/1/Report).

26. In policy terms, that it may be hard to justify Principle 7(1)(b) may be illustrated by the facts in *Lehman Brothers Commodity Services v Credit Agricole Corporate and Investment Bank* [2011] EWHC 1390 (Comm); [2012] 1 All ER (Comm) 254. The case concerns set-off, pursuant to Section 6(f) of the ISDA Master Agreement, between a close-out sum and a sum due under a letter of credit. Imagine the insolvency of the letter of credit provider and that the letter of credit is ordinarily susceptible disclaimer or rejection under national insolvency law. The effect of Principle 7(1)(b) appears to be that, just because the letter of credit is covered by a set-off clause, it becomes immune from disclaimer or rejection. If the national insolvency law's policy is that the letter of credit is generally not immune from disclaimer or rejection, it is hard to see why the mere fact of the letter of credit being covered by a set-off clause should entail the privilege of immunity. Principle 7(1)(b) appears to conflate the close-out netting process with the enforceability of the underlying obligations that may be subject to close-out netting.

27. Protecting a contract from rejection or disclaimer is in principle similar to protecting a contract from insolvency avoidance in respect of transactions entered into within the suspect period – a fact acknowledged in para 122. However, since Principle 7(1)(d) – representing a deliberate change of policy from the former Principle 7(c)(iv) which also conflated the close-out netting process with the validity of the underlying obligations that could be subject to close-out netting – no longer protects contracts from insolvency avoidance in respect of transactions entered into within the suspect period, Principle 7(1)(b) becomes even harder to justify as a matter of both logic and principle. Indeed the logical conclusion appears to be that Principle 7 is self-contradictory.

28. Note that paras 121 and 122 should be deleted as they now appear to be out of date and contradict Principle 7(1)(d). The revision notes dealing with these paragraphs seem mistaken (C.G.E./Netting/2/W.P. 3, p. 13).

29. In summary, our concern is that the policy effect of Principle 7(1)(b) does not seem justified as applied in the context of the Draft Principles. If indeed it is intended that *all* eligible obligations under Principle 4 must be protected from disclaimer or rejection, such a broad safe harbor should be separately considered and justified, and not simply tagged on to the protection of close-out netting.

30. Therefore, we suggest the deletion of Principle 7(1)(b), in line with the policy change with respect to Principle 7(1)(d).

## **Principle 9**

31. Principle 9(2) appears to have unintended effects. In order to demonstrate this concern, we postulate a situation where: (i) a close-out netting provision between a bank and an individual is sought to be enforced in Ruritania (which has enacted the Draft Principles), and (ii) the close-out netting provision is expressed to be governed by the law of Harmonia (which has not enacted the Draft Principles). If Principle 9(2) applies, the following concerns arise:

a) Principle 9(2) would be practically unworkable because the Ruritanian concepts of 'eligible parties' and 'eligible obligations' simply find no equivalent under Harmonian law. The inquiry that Principle 9(2) requires would yield no answer.<sup>8</sup>

b) If the Ruritanian concept of 'eligible parties' does not include natural persons and Harmonian law permits the enforcement of close-out netting against natural persons, requiring a Ruritanian court to nevertheless enforce the close-out netting provision would appear to undermine the policy choices Ruritania has made under Principles 2 and 3.

c) Examples of such potential undermining of Principles 2 and 3 can be multiplied. Imagine that the Ruritanian concept of 'eligible parties' includes a business trust, but Harmonian law does not have the concept of business trust. The application of Principle 9(2) would mean that a close-out netting provision entered into by a business trust would be unenforceable in Ruritania just because it is governed by Harmonian law, despite the fact that the Ruritanian legislature has expressly permitted the enforcement of close-out netting against a business trust.

d) The justification for Principle 9(2) is stated in para 135: "The integrity of the netting set would be destroyed and the risk-mitigation effect of close-out netting nullified if the contractual coverage of a close-out netting provision were to vary according to the jurisdiction in which enforcement of the close-out netting provision is sought." But this 'nullification' argument appears to have overlooked the fact that Principle 9(2)'s application may nullify Principles 2 and 3. And there document does not appear to explain why Principle 9(2) should nullify Principles 2 and 3.

32. A better solution would appear to be the deletion of Principle 9(2). Principle 9(5) would accordingly become redundant.

33. Our key concern here is that Principle 9(2)'s potential practical unworkability and weak justification will confuse the intended audience of the Draft Principles.

34. Moreover, if indeed Principle 9(2) is intended to have the effect that a choice of foreign law to govern a close-out netting provision may override any inconsistent national criteria in respect of eligible parties and eligible obligations, the commentary should make this clear.

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<sup>8</sup> This hypothetical would be real if Harmonian law were the same as the existing English law because English law does not have the concepts of 'eligible parties' and 'eligible obligations' for netting purposes.