Insolvency close-out netting: A comparative study of English, French and US laws in a global perspective

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Introduction

Introduction to the Notion of Insolvency Close-out Netting

In its simplest form, netting is the process by which claims owed reciprocally by two debtors in their bilateral relations are compensated or reconciled with each other so that only one net amount is payable, unless the claims totally extinguish each other. Thus, if two parties enter into various business deals with each other with the result that each of them has various claims against the other under the individual transactions, they may agree on a calculation method by which the various claims are converted into a single amount to be paid by one party to the other. The concept of netting in this basic form resembles the classic concept of *compensatio* or set-off, *i.e.* the cancellation of mutual claims or cross demands, regulated since ancient Roman times.[1]

Derived from the concept of netting, close-out netting is typically a contractual mechanism created by contract which entitles one of the parties, upon the occurrence of a pre-defined event related to the other party's obligation, to liquidate outstanding obligations at a relevant date and reduce the multiple amounts due between the parties to a net amount. The close-out netting process of a standard netting contract comes into operation either by a notification sent by the non-defaulting party upon the occurrence of the termination event or it is triggered automatically upon the occurrence of that event. The mechanism extends to existing or future financial obligations between the parties that are included in the netting contract. Upon close-out, all outstanding obligations are liquidated, and the value of each is determined in terms of a valuation mechanism normally defined in the netting contract itself. The aggregate value of all obligations is calculated to achieve one single payment obligation.

In order to give a numerical illustration of how close-out netting works, it can be assumed that Party A and Party B have entered into numerous transactions between them. When Party A starts to default on its obligations, all outstanding transactions are liquidated, their values calculated and combined into a single net payable or receivable amount. For the purposes of this illustration, it is assumed that the global amount owed by A to B is €1 million whilst the global amount owed by B to A is €800,000. If the contractual arrangements between the two parties does not allow close-out netting,

1 Further analysis of the concepts of *compensatio* and set-off, including their origins in Roman law, and their relationship with netting is made in Chapter 1.2.

then B would have to participate in creditors' joint action to get paid the global amount due by A, whilst B would be forced to pay the whole amount due to A (unless B is otherwise exempt under the contract from making such payment). If close-out netting is permissible, the two amounts are set off against each other and only €200,000 remains owing by A to B.

For the purpose of this research, the term 'insolvency close-out netting' refers to the situation where the close-out netting mechanism is triggered by the insolvency of one of the parties.[2] The event of insolvency is arguably the most important trigger for the mechanism of close-out netting because it is upon insolvency that the more serious risks, in particular systemic risks, are deemed to arise. Systemic risk arises out of interconnectedness between counterparties 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 market participants to fail to meet their own obligations.[3]

The widespread use of netting initially gained momentum in the field of payments and securities settlement, where it was realised that netting schemes could result in significant saving of routine liquidity.[4] In a typical inter-bank payment netting system, the various payment orders entered into the system by the participating clearing banks in favour of other participants are transmitted to a netting agent who calculates the net overall position of each participant at a stipulated cut-off time. Participants with net debit positions effect settlements in favour of participants with net credit positions. Once all settlements have been effected, the individual payment orders of the day included in the netting process are deemed fulfilled. Resort to the netting process is also made in the derivatives[5] and repurchase[6] markets where netting arrangements are essentially bilateral, typically based on master agreements. These are standard market agreements sponsored by market organisations formulated to ensure that in the event of a default by one party the various bilateral transactions between that party and the defaulting party are liquidated in one net close-out amount or exposure. Prime examples of such agreements include the ISDA Master Agreements sponsored by the International Securities and Deriva-

2 The reference to insolvency in this research includes also the analogous term bankruptcy used in some jurisdictions.

3 BIS 1989 Angell Report 10. For a conceptual discussion on systemic risk, see SCHWARCZ (2008); SCOTT (2012); LASTRA (2015) 180.

4 GIOVANOLI (1997) 525. It may be considered generally that modern netting has been used in the financial markets since the 1970s when the first swaps started to be documented. See PEERY (2012) 270.

5 The term 'derivatives' covers a range of products which derive their value from other products or indices. The term does not have a precise legal definition but is taken to cover a range of financial products taking the form of options, forwards and swaps.

6 The term 'repurchase' or 'repo' refers to a contract for the sale and repurchase of securities. For instance, a seller sells bonds to a buyer for an agreed cash price and commits at the same time to buy back equivalent bonds of the same issuer at an agreed future date for the same cash price plus a rate of return called the repo rate.

tives Association, Inc. (ISDA)[7] and the Global Master Repurchase Agreements (GMRA) sponsored by the International Capital Markets Association (ICMA)[8] and the Securities Industry and Financial Markets Association (Sifma).[9] These agreements govern specific transactions or categories of transactions (such as derivatives, foreign exchange transactions, securities lending and repurchase agreements) from time to time entered into by two parties under it – each transaction being recorded in a confirmation exchanged or countersigned between the parties – so that each separate transaction is deemed to form part of a single agreement contained in and subject to the terms of the master agreement.[10]

The modern reference to netting as a financial market tool is probably rooted in a report dating back to 1990, namely the Bank for International Settlements (BIS)[11] *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten countries*, known as the Lamfalussy Report, which concluded that although 'netting can […] reduce the size of credit and liquidity exposures incurred by market participants and thereby contribute to the containment of systemic risk', such 'reductions in exposures, however, depend upon the legal soundness of netting arrangements in producing net binding exposures that will withstand legal challenge.'[12] Since then, a number of jurisdictions worldwide sought to grant recognition to close-out netting and have enacted laws which permit the enforceability of a financial netting contract following the commencement of insolvency proceedings.[13]

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7 ISDA is a private association of dealers in the securities and derivatives markets. Its main achievement has been in developing the ISDA Master Agreements and in promoting the enforceability of their netting and collateral provisions. See ISDA's website at < http://www2.isda.org/about-isda/>.

8 ICMA is a private association operating in the capital markets representing the interests of associated investment banks, asset managers, exchanges, central banks, law firms and advisers. It promotes market conventions and standards in relation to instruments used in the capital markets, such as repurchase agreements. See ICMA's website at <http://www.icmagroup.org/>.

9 Sifma is a US industry trade group representing securities firms, credit institutions and asset management companies. See Sifma's website at <http://www.sifma.org/>.

10 Other important international standard market agreements include the European Master Agreement for Financial Transactions, a multi-product master agreement sponsored by the European Banking Federation; the International Foreign Exchange Master Agreement sponsored by the New York Foreign Exchange Committee; and the Global Master Securities Lending Agreement sponsored by the International Securities Lending Association.

11 The BIS is an international organisation of central banks which fosters international monetary and financial cooperation and serves as a bank for central banks. See the BIS website at < https://www.bis.org/>.

12 BIS 1990 Lamfalussy Report, paras 2.2 and 2.3. See also VEREECKEN & NIJENHUIS (2003), Preface p IX.

13 According to information published by ISDA, there are over seventy jurisdictions which provide for the enforceability of netting contracts in the light of the application of insolvency laws. The list of these jurisdictions is available on the ISDA website at <http://www2.isda.org/functional-areas/legal-and-documentation/opinions/>.

The phrase 'in accordance with its terms' is the term commonly used to denote the standard of enforceability recommended by industry associations for close-out netting provisions. This implies that close-out netting rights are exercised on the basis of a private contract and, generally speaking, are subject to party autonomy.[14] This standard is reflected in arguably the most important legal act of the European Union (EU) harmonising rules on close-out netting, namely Article 7(1) of Directive 2002/47/EC on financial collateral arrangements[15] (the Financial Collateral Directive or FCD) and is also reflected in soft law-type of declarations such as Principle 6(1) of the Principles on the Operation of Close-out Netting Provisions published by the International Institute for the Unification of Private Law (the UNIDROIT Principles).[16] This standard, in its absolute sense, is stated to mean in the explanatory text to Principle 6 of the UNIDROIT Principles that the operation of close-out netting provisions should be governed by the terms agreed by the parties, both before and after the commencement of insolvency proceedings and, as a general rule, the implementing States should not impair the operation of close-out netting provisions by imposing restrictions under national laws and regulations.[17]

The parties typically choose the law applicable to the close-out netting contract, the so-called *lex contractus*, and, outside of an insolvency situation, this law will govern the issues of validity and enforceability of the close-out netting provision. If one of the parties to a netting agreement becomes insolvent, the rules which determine the applicable insolvency law are those of the law of the forum, i.e. the jurisdiction which opens insolvency proceedings over the relevant party, the so-called *lex fori concursus* or *lex concursus*. It is a rule of private international law that the mandatory rules of the *lex concursus* might supersede those of the *lex contractus* to the extent that there is a conflict with the effect of the *lex concursus*, unless there is a specific carve-out under the *lex concursus*.[18]

It is fair to say that guaranteeing the enforceability of insolvency close-out netting has changed the traditional goalposts set by insolvency regimes in a number of jurisdictions. A traditional policy approach of insolvency law generally consists in securing as many assets as possible for the insolvent estate and for this purpose some jurisdictions impose a stay on creditors from enforcing their individual rights. To the extent that close-out netting

14 BöGER (2013) 240.

15 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, [2002] OJ L 168/43, as amended by Directive 2009/44/EC, [2009] OJ L 146/37, and Directive 2014/59/EU, [2014] OJ L 173/190.

16 UNIDROIT 2013 Close-out Netting Principles. UNIDROIT is an independent intergovernmental organisation set up under a multilateral agreement to study needs and methods for modernising, harmonising and co-ordinating private (commercial) law and to formulate uniform law instruments. See its website at < http://www.unidroit.org/>.

17 *Ibid*. 48.

18 See UNIDROIT 2011 Close-out Netting Report 33. See also DALHUISEN (2019) Volume 3, p 410.

is enforceable, claims and assets are not drawn into the insolvent estate but remain immediately available as liquid assets for the netting creditor. The race for the enforcement of claims where the prize goes to the swiftest and individual assets of the insolvent debtor are dismembered in the process of individual execution by the creditors has been considered detrimental to the efficient organisation of the insolvent debtor's affairs by several authors since it dismembers parts of the estate and may significantly frustrate the possibility to rehabilitate the debtor. Indeed, following the financial crisis of 2008-2009, the extent of the enforceability of close-out netting provisions in the case of a failure of an important financial market player has been questioned.[19] This is evident in recent statements and developments regarding the effectiveness of resolution measures in respect of credit institutions and certain investment firms where it is recommended that resolution authorities should be empowered to impose a temporary stay on the termination rights exercisable under close-out netting provisions in order to decide whether to transfer in full or not at all the obligations falling under a netting agreement.[20] Such measures have been adopted, for instance, in the EU in terms of national measures implementing Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms[21] (the Bank Recovery and Resolution Directive or BRRD), which is to be considered together with Regulation EU/806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund[22] (the Single Resolution Mechanism Regulation or SRM Regulation). The main reason for

19 See, in particular, the views of US academics in this respect, e.g. LUBBEN (2010) 319; AYOTTE & SKEEL (2009) 494; SKEEL & JACKSON (2012) 153; ROE (2011) 541; TUCKMAN (2010) 3.

20 See FSB 2011 Key Attributes, Sections 4 & 5.

21 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/30/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, [2014] OJ L 173/190, Articles 71, 76 & 77. The BRRD has been amended by the so-called BRRD II, *i.e.* Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC, [2019] OJ L 150/296.

22 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] OJ L225/1. The SRM Regulation has been amended by the so-called SRM II Regulation, *i.e.* Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms, [2019] OJ L 150/226. SRM II will apply from 28 December 2020.

this development is that close-out netting should not frustrate the orderly implementation of resolution measures to the detriment of the financial stability of the markets, provided adequate safeguards for the close-out netting provision are in place.[23]

A Research Methodology

A.1 Research Question

The close-out netting process, when it takes effect 'in accordance with its terms' in insolvency, has provided financial market participants with a substantial measure of self-help in enforcing their claims against an insolvent counterparty. Whilst the recognition granted to close-out netting provisions is now globally widespread,[24] the extent to which recognition is given by national legislators to the standard set by industry, i.e. recognition 'in accordance with its terms', may vary from one jurisdiction to another. The term 'recognition' is an important term of the research question and will be frequently used throughout this research, at times in conjunction with the term 'enforceability' or 'enforcement'. It is considered in modern literature in the analogous context of foreign judgments and arbitral awards that the distinction between recognition and enforcement does not have significant practical value since international enforcement conventions do not establish separate procedures for recognition and enforcement, *i.e.* there is no double *exquatur*.[25] Traditionally, however, a distinction is typically drawn between the two terms. Thus, recognition refers to the situation where the law or the court recognises the legal force and effect of a legal concept, contractual provision or decision, whilst enforcement or enforceability refers to the faculty to carry out and execute, apply or implement such concept, provision or decision, possibly (and depending on the case) by imposing legal sanctions.[26] Given that the recognition of a concept is the first step of the process which may later lead to its enforceability, predominant use in this research will be made to the aspect of recognition of a close-out netting provision. This is consistent with the terminology used under the EU's Financial Collateral Directive which in the heading of Article 7 refers to the 'Recognition of close-out netting provisions' whilst the text of Article 7(1) refers to a close-out netting provision taking effect in accordance with its terms, this (i.e. 'takes effect') being a reference to one aspect stemming

23 For a general understanding of the notion of 'financial stability' in the context of this research, see MOFFATT (2015) 493.

24 ISDA announces on its website that it has legal opinions on the enforceability of close-out netting in seventy-five jurisdictions. See <https://www.isda.org/opinions-overview/> accessed 26 December 2019.

25 BUNGENBERG & REINISCH (2019) 480.

26 KRONKE *et al.* (2010) 150.

from recognition. However, elements of enforceability will also be analysed in this research as it may at times be difficult to establish when recognition ends and enforceability begins. For instance, in the case of mandatory insolvency laws which may affect the implementation of close-out netting provisions, is this a case of partial recognition or partial enforcement? Thus, whilst the main process referred to in this research is to recognition of close-out netting, it is not excluded that reference will also be made to enforceability where use of this term is deemed more appropriate.

This research is based on the premise that close-out netting developed as a market tool under the *lex mercatoria* based primarily on the (private and cross-border) standard rules or master agreements of market associations and, secondarily on external factors such as declarations and recommendations of international regulatory bodies which are deemed to have produced a transnational effect on the development of close-out netting. Based on this premise, this research will examine the influence of the legal systems of England (*i.e.* England and Wales), France and the United States of America (US) on the recognition of close-out netting provisions in insolvency. In more detail, the research will consider (i) whether the development of the concept of close-out netting in these jurisdictions has been influenced by the respective jurisdiction's set-off rules or whether close-out netting has developed as an autonomous concept, (ii) whether the recognition given to close-out netting 'in accordance with its terms' has been affected by the norms and rules of the jurisdictions' national insolvency laws and state insolvency goals (and, if so, in what manner), and (iii) whether, following the global financial crisis of 2008 – 2009, a convergence can be noted in (restrictions imposed on) the recognition of close-out netting provisions under these jurisdictions' national resolution regimes (and, if so, in what manner).

The choice of these jurisdictions has been motivated by the fact that they pertain to different global legal systems which is expected to bring out differences in the development of insolvency close-out netting as a consequence of their diverse historical and legal heritage. Thus, English law is fundamentally based on the common law tradition. French law, on the other hand, operates a civil law system based on Roman law, initially codified through the Napoleonic Code.[27] US law, though following the common law tradition brought to the North American colonies from England, has traces of the civil law tradition in its state legal systems[28] and may, to some extent, be considered as an eclectic system comprising elements of the civil and common law system and also home-grown elements.

On the basis of the above considerations, the main question to be addressed in this research is therefore the following:

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27 *Code civil des Français,* Law 1804-02-07.

28 Most notable is the case of Louisiana, where state law is based on civil law on account of its history as a French and Spanish territory prior to its acquisition from France in 1803.

How does close-out netting in insolvency function under current English, French and US laws, and, more specifically, how have the legal systems of these jurisdictions influenced the recognition of insolvency close-out netting provisions?

Thus, the topic of close-out netting in insolvency under present English, French and US laws is approached from a historic-theoretical perspective. In order to address this main question, a number of ancillary questions will be tackled as indicated below:

(a) First, in what ways has the classic concept of set-off under the three selected jurisdictions influenced the recognition of close-out netting provisions? Is close-out netting considered a contractual enhancement of set-off or is it a stand-alone concept having its foundations in the *lex mercatoria*?
(b) Second, in what ways has the recognition of close-out netting provisions 'in accordance with their terms' been affected by the principles of national insolvency laws and by State insolvency goals?
(c) Third (and final), following the global financial crisis of 2008 – 2009, has there been a convergence in relation to the type of restrictions imposed on the enforceability of close-out netting provisions under the national resolution regimes? Which aspects of the *lex mercatoria* may have contributed to such development?

It will be explained in more detail how the research question and sub-questions will be tackled in the part of this Introduction dealing with the structure of the research. Beforehand, it is proposed to first provide a brief understanding of the concepts of legal systems and the *lex mercatoria* as used in this research.

A.2 Origins of the Common and Civil Law Systems

Chapters 4 to 6 of this research are dedicated to a comparative study of the regulation of insolvency close-out netting under English, French and US laws. A brief description of the salient points of the history and of the characteristics of the common and civil law traditions may assist in understanding the historical foundations for the development of the insolvency close-out netting laws of the three selected jurisdictions and their preparedness to adapt to the *lex mercatoria*.[29]

The common law tradition emerged in England during the Middle Ages and was later exported to British colonies across continents, including the US. In the Middle Ages justice was delivered by a system of *writs*, or royal orders, emanating from the king, each providing a specific remedy for a specific wrong. Since this system did not adequately achieve justice,

29 A detailed analysis of the common and civil law systems is outside the scope of this research. See for a detailed analysis, TETLEY (2000); APPLE & DEYLING (1995).

a further appeal could be made to courts of *equity* presided by judges appointed by the king. The king's judges were obliged to adopt an earlier judge's interpretation of the law and apply the same principles if two cases were based on similar facts. The term common law was gradually used to describe the law held in common in these courts.[30] Common law has developed a number of distinguishing characteristics. It is generally uncodified, meaning that there is no comprehensive compilation of legal rules and statutes, and is largely based on precedent, meaning that if a similar dispute has been resolved in the past, the court is usually bound to follow the same reasoning (known in Latin as *stare decisis*). If, however, the court finds that the current dispute is fundamentally distinct from all previous cases, judges have the authority and duty to make law by creating precedent. As a result, judges have a notable role in developing the law. The common law process is thus based on inductive reasoning, deriving general principles or rules of law from precedent and extracting an applicable rule to be applied to a particular case. Statutes in a common law jurisdiction tend to be comprehensive, provide detailed definitions, each specific rule sets out lengthy enumerations of specific applications or exceptions and are interpreted to meet the subjects' reasonable understanding and expectations. Common law moves from case to case, is factual and results-oriented, and leaves room for other sources of law in trade, commerce and finance, especially industry practices or customs supported by party autonomy and therefore by the order that participants themselves create. The former distinction between law and equity was also important for the development of commercial and financial law in common law systems. Thus, Dalhuisen notes that certain features of the ordinary law of contracts, such as the concept of consideration does not affect certain commercial agreements such as the agreement to transfer negotiable instruments, implemented through delivery or endorsement. This underscores the point that integration between ordinary (common) law and commercial law (formerly based on other sources such as equity and custom) may not fully exist in common law countries.[31]

The civil law tradition developed in continental Europe at the same time and was applied in the colonies of European imperial powers such as Spain and Portugal. The term civil law derives from the Latin *jus civile*, the law applicable to all Roman citizens. Its origins derive from the Justinian Code of the sixth century, a codification which was strongly influenced by the opinions of jurists sought by lay Roman judges. This Code was re-discovered and taught in universities in the eleventh century in Italy.

30 In the seventeenth century the English Parliament claimed the right to define the common law and declared other laws subsidiary to it. The first systematic treatise on English common law was drafted by William Blackstone in his *Commentaries on the Laws of England* (1723-1780). Parliament later acquired legislative powers to create statutory law, but this was considered to apply as complementary to the older common law rules.

31 DALHUISEN (2019) Volume 1, p 20.

Medieval scholars of canon law were also influenced by Roman law as they compiled existing religious legal sources for their own comprehensive system of law for the Church. By the late Middle Ages, these two laws, civil and canon, constituted the basis of a shared body of legal thought common to most of continental Europe giving rise to the medieval *Corpus juris civilis*. The role of local custom (known as law merchant) as a source of law became increasingly important and during the early modern period this led to academic attempts to codify legal civil law provisions and local customary laws.[32] Such codes, shaped by the Roman law tradition, are the models of today's civil law systems.[33] The traditional characteristic of the civil law system is the codification of legislation so that the commercial and financial laws of the country are part of this codification process which is complete and capable of finding solutions for all eventualities. The first step in interpreting an ambiguous law is to discover the intention of the legislator by examining the legislation as a whole, including the *travaux préparatoires*. Dalhuisen remarks that the approach is rule-oriented and change is dependent on legislation by the state, with the legislator making the necessary choices and ultimately also determining the relevant values. Notwithstanding this, civil law codes and statutes are concise and provide no or few definitions. The reasoning process is deductive – conclusions about specific situations are derived from general principles. Case law is advisory, but not binding, when there is a long series of cases using consistent reasoning (known as *jurisprudence constant*). The law is not typically analysed for its continuing fairness or morality, efficiency or responsiveness to social or economic needs. The system is closed and extraneous sources of law are irrelevant with the result that custom and party autonomy can only operate to the extent the written law specifically permits. According to Dalhuisen, this strict approach to party autonomy goes far beyond the ordinary constraints derived from public order and public policy considerations which parties must respect and accept as overriding. It concerns the validity of the agreement itself, which depends on express legislative recognition.[34]

These traditional characteristics of the civil and common law systems have led to distinct approaches in the development of their laws. First, although common law judges are bound by precedent, they may re-inter-

32 The most distinguished of these scholars is the Dutch jurist Hugo Grotius whose 1631 work, *Introduction to Dutch Jurisprudence*, synthesized Roman law and Dutch customary law into one compendium. See APPLE & DEYLING (1995) 12 *et seq.*

33 The leaders of the codification process in modern continental Europe were France and Germany. In France the *Code Napoleon* of 1804 was disseminated in countries conquered by Napoleon's armies. Its structure is influenced by Justinian's *Corpus Juris Civilis*. Its language is simple and clear, since it was designed to be understood by every citizen. The Napoleonic Code has been amended and supplemented by later legislation but has not been completely revamped. The German *Bürgerliches Gesetzbuch* or BGB of 1900 is largely the product of codification processes in three Germanic states: Bavaria, Prussia and Austria. *Ibid.* 14, 20.

34 DALHUISEN (2019) Volume 1, p 9.

pret and revise the law without legislative intervention to adapt to new trends in political, legal and social philosophy. This causes common law to evolve through a series of gradual steps, so that over a decade or more the law can change significantly and new concepts may enter the legal system in response to the changing needs of society. Second, common law provides the precise law that applies to a particular set of facts by locating precedential decisions on the topic. This provides an element of certainty of application of the law and renders commercial contracts more economically efficient. Third, traditionally there is a tendency for common law jurisdictions to have pro-creditor laws, whilst civil law jurisdictions whose laws originate from the Napoleonic Code such as France are generally pro-debtor in their approach to insolvency. The relevance of this distinction is that whilst the insolvency regimes of common law jurisdictions tend to recognise the right of creditors to protect themselves against default through *ex ante* contractual agreements that permit the solvent counterparty to close out contracts and net obligations, civil law jurisdictions traditionally seek to maximise the value of the insolvent estate with the result that preferential privately-negotiated *ex ante* contractual arrangements may be rendered ineffective during insolvency judicial proceedings.[35] The selection of jurisdictions has therefore been made with the intention of bringing out contrasts in the application of their insolvency close-out netting laws under the assumption that these are influenced by the diverse traditions of their legal systems.

A.3 Definition of *Lex Mercatoria*

One of the aspects examined in this research is the influence of the *lex mercatoria* on the development of the close-out netting laws of the three selected jurisdictions. In this part an understanding of the term *lex mercatoria* for the purposes of this research is provided. First, in order to appreciate the diversity of this concept, the views of some authors on what constitutes the *lex mercatoria* is synthesised below. This is followed by a description of those elements of the *lex mercatoria* which are considered relevant for the purposes of determining its influence on the development of the three selected close-out netting regimes.

There is broad consensus in doctrine that the *lex mercatoria* is related to commercial and financial law and is based on international dealings or professional cross-border activities. It transcends the national legal system and emanates from a legal order of its own. Apart from this general understanding, there are somewhat diverse views on what constitute the sources of the *lex mercatoria*. Dalhuisen considers that the *lex mercatoria* is not national or territorial and results from the spontaneous bottom-up law

35 According to Bergman *et al.*, these approaches 'have at their roots two fundamentally irreconcilable concepts of fairness'. BERGMAN *et al.* (2004) 7.

formation in which custom and practices, treaty law, general principle and party autonomy play the defining roles. It is thus, according to this author, not a single systematically coherent body of law but is the result of a hierarchy of these various sources of law which will seek to rearrange the risks and financial consequences normally foreseen under national law. Goode also confines the *lex mercatoria* to international trade practice related to the spontaneous generation of instruments of harmonisation and which results from a variety of forms of soft law, including model laws, legislative guides, contractually incorporated uniform rules, trade terms promulgated by international business organisations and international restatements by scholars. He considers that contracts cannot by themselves constitute a source of law since they have effect only by virtue of recognition by a national legal system and are restricted by rules of public policy or mandatory rules. He considers that the *lex mercatoria* should not be dependent on external legal recognition and its effectiveness lies in the fact that the industry perceives its observance as necessary to the fair and efficient conduct of business.[36] Druzin's views combine elements of both approaches taken by Dalhuisen and Goode. Thus, similar to Dalhuisen's view, Druzin considers that the *lex mercatoria* unfolds both on the macro level of state actors where its sources are complex international agreements, as well as on the micro level where the driving force are private contracts resorting to customary law and international arbitration. Similar to the views of the other two authors, he describes the *lex mercatoria* as a commercial transnational legal order that possesses built-in structural features that allow it to self-standardize and sustain itself without a central authority.[37]

Although there is no general agreement of what constitutes a source of law for the purposes of defining the *lex mercatoria*, there is a general understanding that the *lex mercatoria* is constituted by a hierarchy of various sources of what have been termed by Goode as 'soft law'. This implies that

36 GOODE (2005) 547. Notwithstanding this assertion, Goode cites the case of the 2001 Cape Town Convention on International Interests in Mobile Equipment as the most ambitious problem-solving convention regulated by its own Supervisory Authority and which aims to address the problem of taking and retaining rights *in rem* in assets such as aircraft objects, railway rolling stock and space assets that are constantly moving from one jurisdiction to another or, in the case of satellites, are not on earth at all. *Ibid.* 557.

37 DRUZIN (2014) 1052. By way of summary, Druzin considers that three elements are key to the transnational legal order created by the *lex mercatoria*, namely reciprocity, the practical requirements of the market and the existence of network effects. First, reciprocal gains from the recognition of the rules of property and contract stimulate voluntary compliance. Second, the requirements of the market tend to create a degree of general uniformity in these practices because uniformity itself provides a benefit. Commercial legal structures emerge in the form of instruments of the market, formulated spontaneously in a decentralised fashion out of sheer practical necessity. Because these legal structures emerge in line with the needs of the market, and because these needs tend to be the same everywhere, a degree of general uniformity results. Third, high degrees of uniformity arise as network effects push the market for legal rules toward ever-higher levels of standardisation. *Ibid.* 1056, 1075, 1079.

although these sources are not directly binding in national regimes, they command a sufficient strong and consistent following in financial and commercial societies as to form an identifiable and morally cogent normative regime.[38] Applying this understanding to the development of close-out netting regimes, relevant sources for a *lex mercatoria* are those that may have influenced legislators in adapting national laws to grant recognition to close-out netting provisions developed on the basis of party autonomy. The sources identified in this respect are custom, party autonomy, standard-term international agreements, model laws and legislative guides. Chapter 3 will enumerate and explain those sources which are deemed to have instigated the promulgation of national close-out netting regimes, amongst which are the reports of public international bodies such as the Lamfalussy Report of the Committee on Interbank Netting Schemes of the BIS (1990),[39] the Giovannini Report (2001),[40] the World Bank Principles for Effective Creditor Rights and Insolvency Systems (2001),[41] the United Nations Commission on International Trade Law (UNCITRAL)[42] and the Legislative Guide on Insolvency Law (2004).[43] Chapter 3 will also consider sources related to private association efforts to promote the global statutory recognition of close-out netting provisions, foremost among these is ISDA

38 A similar view is expressed by Mevorach that what may have initially started as a 'soft law' may become a source of law through the influence of peer pressure. Mevorach opines that universalism can crystallise into binding law in the form of 'customary international law' where there is belief that a practice conforms to international law. See MEVORACH (2018) 259.

39 BIS 1990 Lamfalussy Report.

40 EUROPEAN COMMISSION 2001 Giovannini Group First Report, Barrier 14.

41 WORLD BANK Principles (2001), Principle 14. The World Bank is a United Nations international financial institution created out of the Bretton Woods Agreement in 1944 to provide finance to European and Asian countries needing finance to fund reconstruction efforts after the Second World War. Today it is dedicated to provide finance, advice and research to developing nations to aid their economic development. See the World Bank's website at < http://www.worldbank.org/>.

42 UNCITRAL is a legal body of the United Nations in the field of international trade law specialising in commercial law reform. See its website at <http://www.uncitral.org/>.

43 UNCITRAL Legislative Guide (2004), Recommendations 7(g) and 101-107. The UNCITRAL Legislative Guide is divided in four parts. Part one discusses the key objectives of an insolvency law and structural issues such as the institutional framework required to support an effective insolvency regime. Part two deals with core features of an effective insolvency law. Part three (adopted in 2010) addresses the treatment of enterprise groups in insolvency, both nationally and internationally. Part four (adopted in 2013) focuses on the obligations that might be imposed upon those responsible for making decisions with respect to the management of a failing enterprise. Work proceeded through a joint colloquium with the Association of International Insolvency Practitioners (INSOL), a worldwide federation of national associations for accountants and lawyers who specialise in insolvency, and the International Bar Association (IBA), a global organisation of international legal practitioners, bar associations and law societies. The Legislative Guide was adopted by the United Nations General Assembly on 2 December 2004.

with its master agreements and its ISDA Model Netting Law.[44] Chapter 3 will further assess the impact of EU law in the area of close-out netting which is foremost a primary (binding) source of law for EU Member States but which may have exerted influence beyond the EU for other countries who wish to remain competitive in the market and may thus be considered as a special *lex mercatoria*.

It is interesting to note the remarks made by Dalhuisen and Goode on the congruence or acceptance of the *lex mercatoria* in common and civil law jurisdictions. Dalhuisen remarks that the *lex mercatoria* in international dealings partakes of the characteristics of common law and this is apparent in the greater reliance on practices, custom and party autonomy, in its operating from case to case, its sensitivity to the facts and in supporting new business structures.[45] Goode notes that the *laissez-faire* approach of the *lex mercatoria* is much less acceptable to civil law jurisdictions where a number of rules particularly in property law are incompatible with modern methods of dealing and finance.[46] Both authors agree that modern states wanting to benefit from globalisation are likely to adjust their regulatory regimes to transnational standards in order to create a more level playing field for market players. It may therefore be the case that also modern civil law jurisdictions are amenable to adapt their laws as a response to the needs of international commerce and finance to ensure that their legal systems remain competitive.

A.4 Methodology

This research considers a number of laws regulating close-out netting. From an EU perspective, it analyses the relevant close-out netting provisions of, *inter alia,* Directive 98/26/EC on settlement finality in payment and securities settlement systems (the Settlement Finality Directive),[47] the Financial Collateral Directive, the Bank Recovery and Resolution Directive in conjunction with the Single Resolution Mechanism Regulation and Directive 2001/24/EC on the reorganisation and winding up of credit institutions ('the Banks Winding-Up Directive').[48] The research also includes a comparative analysis of the insolvency close-out netting laws of (i) England

44 There are various versions of the ISDA Model Netting Law, the most recent being the 2018 ISDA Model Netting Act and Guide (October 15, 2018).

45 DALHUISEN (2019) Volume 1, 25.

46 GOODE (2005) 541.

47 Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems, [1998] OJ L 166/45, as amended by Directive 2009/44/EC, [2009] OJ L146/37, Regulation (EU) No 648/2012, [2012] OJ L 201/1 and Regulation (EU) No 909/2014, [2014] OJ L 257/1.

48 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, [2001] OJ L 125/15, as amended by Directive 2014/59/EU, [2014] OJ L 173/190.

(mainly the Financial Collateral Arrangements (No. 2) Regulations 2003,[49] the Insolvency (England and Wales) Rules 2016[50] and the Banking Act 2009[51]); (ii) France (the Civil Code, the Commercial Code and the Monetary and Financial Code); and (iii) the US (the Bankruptcy Code,[52] the Federal Deposit Insurance Act of 1950 (FDIA),[53] the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA)[54] and Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)).[55] To the extent they are illustrative or contribute to the development of law, important judgments delivered in these jurisdictions are also cited.

Reference is also made to international best practice guidelines issued by international organisations on the drafting of national netting legislation, such as the UNIDROIT Principles on the Application of Close-out Netting, the UNCITRAL Legislative Guide on Insolvency Law and the ISDA Model Netting Act which provide recommendations to legislators on how to design legislation on insolvency close-out netting. Reference will also be made to reports of the BIS, including its sub-structures, the Financial Stability Board (FSB),[56] the International Monetary Fund (IMF)[57] and the World Bank insofar as these provide important declarations on the role of insolvency close-out netting in the financial markets.

The close-out netting instruments typically concluded by financial market participants are the standard master agreements. This research analyses the close-out netting provisions of two important master agreements, namely the 2002 ISDA Master Agreement used for derivatives transactions and the 2011 Global Master Repurchase Agreement. The implications of the close-out netting provisions of these master agreements provide insight into the different ways in which the close-out netting technique operates in the derivatives and repurchase markets.

These prime sources are supplemented by the writings of European and US academics in the fields of close-out netting, set-off and insolvency. Material used has been sourced through academic research and digital research, and all sources used are publicly accessible through on-line sources or

49 S.I. 2003/3226.
50 S.I. 2016/1024.
51 2009 c. 1.
52 Title 11 of the United States Code, 11 U.S.C.
53 Pub.L. 81-797, 64 Stat. 873.
54 Pub.L. 102-242, 105 Stat. 2236.
55 Dodd-Frank Wall Street Reform and Consumer Protection Act (June 21, 2010) (Pub.L. 111-203, H.R. 4173).
56 The FSB is the successor to the Financial Stability Forum set up by the Group of Twenty to promote the reform of international financial regulation. See its website at < http://www.financialstabilityboard.org/>.
57 The IMF is an international organisation having 188 member countries which was set up in 1945 to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable growth, and reduce poverty in the world. See the IMF's website at <http://www.imf.org/external/index.htm>.

libraries or other public sources.[58] This research therefore follows the classic legal methodology and is limited to the use of legal texts, case law and standard market agreements. It does not purport to cover issues related to private international law, except to the extent this is inevitably linked with the assessment of the research question, nor does it attempt to study the role of close-out netting in the regulated markets of central counterparties and central securities depositories. This research focuses on the operation of close-out netting provisions in bilateral arrangements mainly in the derivatives and repurchase markets, though reference may be made to the securities lending, payment systems and inter-bank deposit markets when required to strengthen arguments expounded in this research.

B Structure of the Research

This research is divided into three parts and eight chapters.

In Part I (Introductory Chapters: Close-out Netting, Insolvency Law and Global Perspectives), Chapter 1 discusses the constitutive elements of the concept of close-out netting, its historical evolution from set-off and its use by the market in two cross-border master agreements. This chapter considers from a theoretical point of view the relationship between close-out netting and set-off and provides preliminary views on the first sub-question, namely whether close-out netting may, in theory, be considered as a contractual enhancement of the classic concept of set-off. Chapter 2 analyses the interaction between close-out netting provisions and insolvency law, focusing on the main derogations granted to ensure protection of close-out netting provisions from insolvency law. This chapter answers the second sub-question and indicates how national insolvency laws generally tend to restrict the contractual freedom of the parties in their recognition of close-out netting provisions. It also provides a theoretical answer to the third sub-question by indicating the ways in which banking resolution regimes have reshaped the recognition granted by national regimes to close-out netting provisions. Chapter 3 considers the two sources which are deemed in this research to have established a *lex mercatoria* in relation to the development of close-out netting, namely (i) the recommendations made by international regulatory bodies and the standard market documentation or agreements of private global market associations on the one hand and (ii) EU law in the field of close-out netting on the other. These first three chapters are intended

58 Whilst every effort has been made to cite the most recent or most relevant academic writing, the author wishes to state that the latest version of the publication of Philip R Wood, *Set-off and Netting, Derivatives, Clearing Systems.* (Third Edition, Sweet & Maxwell 2018) was not available even though a number of libraries and sources have been accessed for this purpose at the time of writing. Reference in this research has therefore been made to the Second Edition of this publication.

to provide a theoretical overview of the main conceptual elements used in this research and to indicate how they interact with each other.

In Part II (National Close-out Netting Regimes), each of Chapters 4, 5 and 6 analyses the extent of the recognition granted to insolvency close-out netting provisions under the laws of England, France and the US, respectively. These chapters examine for each of these jurisdictions (i) the historical development of close-out netting law and the constitutive elements of close-out netting under current law with a view to establishing the extent of recognition granted by the legislator to close-out netting, (ii) the influence which set-off rules have exerted on the development of close-out netting, (iii) the effect of national insolvency law as well as the insolvency goals pursued by the State on the type of recognition given by the legislator to close-out netting and (iv) the identification of new restrictions and safeguards to close-out netting heralded by national resolution regimes following the financial crisis of 2008 – 2009 in order to safeguard financial stability. In this Part II, sub-questions 1 to 3 will be analysed from the point of view of the national law of the three selected jurisdictions and preliminary conclusions will be drawn for each of these sub-questions in preparation for the comparative analysis carried out in Chapter 7.

In Part III (Comparative Analysis and the Influence of the Legal Systems), Chapter 7 undertakes a comparative analysis of all the aspects considered in Chapters 4 to 6 in order to establish approaches taken by legislators in formulating their close-out netting regimes. This comparative analysis also draws distinctions between the three selected jurisdictions in relation to the subject-matter of the three sub-questions, namely the extent to which close-out netting is influenced in its development by set-off rules, the effect which national insolvency principles and state insolvency goals may have had on the recognition of close-out netting provisions, and the level of harmonisation in the type of restrictions and safeguards imposed on the recognition of close-out netting by national resolution regimes. This analysis is then used in Chapter 8 to draw conclusions on the influence of the legal system of the three selected jurisdictions on the recognition granted to close-out netting provisions as developed under the standards of the *lex mercatoria* in reply to the main research question.

C Importance of the Research Question

Close-out netting is a core provision of financial netting agreements and of most collateral transactions. Industry associations, particularly in the derivatives markets, typically commission national legal opinions to ensure, to the extent possible, that reliance on the enforceability of close-out netting provisions in cross-border contracts can be safely made especially in an insolvency event. The motivation behind the choice of the research question is that firstly it aims to map the national law regimes of England, France and the US on close-out netting within these regimes globally. Secondly,

to better understand the functioning of the present day's close-out netting regimes, it seeks to examine from various perspectives the adaptability and amenability of the national law regimes of these jurisdictions to accommodate this important contractual provision. Finally, it serves to demystify stereotypes which have come to be associated with certain jurisdictions in their approach and readiness to uphold debtors' or, alternatively, creditors' rights. Thus, this analysis goes beyond a mere legal assessment of the current, relevant national close-out netting provisions and how these are applied in the relevant jurisdictions. Rather, this thesis takes into consideration a wider range of influences of the legal system and of state goals which have arguably left their mark on the level of recognition granted to close-out netting provisions. The analysis will therefore take into account legal, political, moral, philosophical and other relevant factors and as a result assesses not only the level of legal recognition (including any limitations thereto) granted by these regimes to close-out netting but also the reasons and influences which led to that recognition.

Three perspectives are taken to formulate the reply to the main research question, selected to provide a holistic assessment of the nature and shape of close-out netting. The first relates to a comparison of close-out netting with the analogous general concept of set-off in commercial transactions and will thus focus on substantive private law. These two concepts are often compared in literature, albeit in a rather general way. In this research the comparison is intended to delineate the historical and current influences which served to cast the concept of set-off and considers whether these influences have been perpetuated in the development of close-out netting. The second perspective relates to the application of insolvency law and will focus on public policy issues. Insolvency law often functions as mandatory national law. It is therefore deemed that the type and extent of derogations granted from the application of insolvency law principles provide a good indication of the influence of a state's insolvency goals on the recognition given to close-out netting provisions as well as the pro-creditor or pro-debtor approach taken by the national legislator. The third perspective relates to the influence of bank resolution regimes and will focus on the implementation of public interest objectives with cross-border implications. The impetus for the enactment of national resolution regimes is due to an international movement advocating the orderly resolution of systemically important financial institutions based on the pursuit of objectives related to, inter alia, the stability of the financial system and protection against systemic risk. It is expected that the international dimension of these regimes transcends the influence of the applicable legal systems and should result in a level of convergence of certain aspects of national netting laws. Further insight into these different perspectives will be provided in this research.