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

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3 Introduction to *Lex Mercatoria* and Close-out Netting

3.1 *Lex Mercatoria* and the Development of Close-out Netting

It is generally an undisputed fact that close-out netting first developed as a market tool under the *lex mercatoria* and was eventually granted recognition by national legislators to provide legal certainty to netting counterparties that they can rely on their contractual netting rights. It is the scope of this chapter to consider the sources of the *lex mercatoria* as defined in the Introduction which are deemed to have led to the development of close-out netting and to have influenced this global statutory recognition of close-out netting provisions. The chapter will commence with an overview of the statements issued by public and private international bodies in relation to the recognition of close-out netting before the financial crisis of 2008-2009. These sources provided the necessary impetus globally for national legislators to grant statutory recognition to close-out netting provisions 'in accordance with their terms'. In the second part note will be taken of the restrictions and safeguards to the exercise of close-out netting rights advocated by public bodies in the wake of the financial crisis in order not to hamper the effectiveness of resolution measures. These sources were influential in retracting, in part, the recognition given by national legislators to close-out netting on the basis of contractual freedom due to financial stability considerations. In the third part, an analysis is made of the regulation of close-out netting under EU law, also considered to be a source of special *lex mercatoria* given that this law influenced not only the netting laws of EU Member States but possibly also beyond as will be seen in Part III of this research. The manner in which these sources of *lex mercatoria* may have influenced the development of the netting laws of England, France and the US will be considered in Chapter 8.

3.2 The Development of Close-out Netting by the Financial Markets

This part reviews a number of international developments which paved the way for the global statutory recognition of close-out netting. In addition to enumerating the sources of *lex mercatoria* relating to the development of close-out netting, the aim of this overview is twofold. First, it provides a historical understanding of how supranational bodies and the industry perceived the usefulness of close-out netting in averting risks facing financial institutions, in particular in the derivatives markets. Second, it manifests the change in attitude of international regulatory bodies before and after the financial crisis towards the effect of close-out netting provisions on systemic risk. This change in approach served to further shape the development of close-out netting in the market. It is proposed to start with the declarations made by public international bodies, followed by the documents and instruments issued by private market associations.

3.2.1 Early International Reports on the Netting Process

Arguably, the first formal international recognition of the close-out netting mechanism was made in the Angell Report on Netting Schemes prepared in February 1989 by the Group of Experts on Payment Systems of the central banks of the Group of Ten countries under the auspices of the BIS. The study is based on an analysis of various netting arrangements entered into by banks in relation to financial netting schemes for foreign exchange contracts and payment transfers. The report concludes that based on the assumption that close-out netting provisions are enforceable, arrangements which net outstanding financial or payment obligations reduce liquidity risk and also systemic risk since the netting calculation allows settlement payments due from a counterparty to be used to settle payments due to the counterparty, but it leaves counterparty credit risk unchanged since the gross obligations underlying the netted amount are not extinguished or may even induce risk if net exposures are treated as if they were 'true exposures'.[1]

The Angell Report was followed by the Lamfalussy Report prepared by the Committee on Payments and Settlement Systems of the BIS in November 1990. This report considers the advantages of netting in terms of improving the efficiency and stability of interbank settlements by reducing costs and risks and considers that the effective reductions in exposures depend on the legal soundness of netting arrangements. Otherwise, the report states, uncertainty as to the legal soundness of a netting scheme will serve to exacerbate systemic risk as it obscures the level of exposures.[2]

The Lamfalussy Report constituted a point of reference in a number of other important reports or recommendations made by international organisations. Thus, the Giovannini Group which was set up by the European Commission Directorate-General for Economic and Financial Affairs to report on barriers in the EU leading to fragmentation in the cross-border clearing and settlement arrangements indicated in its November 2001 report that one important barrier relates to the national differences in the legal treatment of bilateral netting for financial transactions. This Giovannini Report notes that the principle that mutual obligations arising in financial

1 See BIS 1989 Angell Report, 6 & 14. It is important to note that the Angell Report was written at a time when legal regimes on the finality and irrevocability of payment transfers were not yet in force and as a result it was still fairly possible to unwind transfer orders and netting instructions, especially upon insolvency of a participant.

2 BIS 1990 Lamfalussy Report, 7.

market transactions may be netted has been accepted throughout the EU. It further notes that this arises in some countries as a natural feature of their legal system (as it is the case in Germany and the UK) and in others by virtue of specific legislation passed for the purpose (as it is the case in Spain and France). According to the report, where netting has been introduced by such legislation, its availability is normally limited to specific products, types of counterparty or forms of contractual documentation. This leads to the need for detailed analysis of the relevant features of a transaction before it can be safely assumed that netting is available. The report therefore advocates the removal of all remaining legal uncertainties as to netting, especially if multilateral netting schemes are to be established in the context of clearing systems.[3]

At the same time when the Giovannini Report was published in the EU, the World Bank issued its 2001 Principles for Effective Creditor Rights and Insolvency Systems designed as a broad-assessment tool to assist countries in their efforts to evaluate and improve the core aspects of their commercial law systems required for a sound investment climate and commerce. In its Principle 14 on treatment of contractual obligations, it is recommended that the law should allow for interference with contractual obligations that are not fully performed to the extent necessary to achieve the objectives of the insolvency process, whether to enforce, cancel or assign contracts, except where there is a compelling commercial, public or social interest in upholding the contractual rights of the counterparty to the contract. In its explanatory text on Principle 14, the World Bank recommends the enactment of carve-outs for financial and derivative contracts from national insolvency laws mainly due to the fact that use is made of derivative contracts in risk hedging of international transactions that demands the highest level of certainty for the international community.[4]

In 2004 UNCITRAL adopted a Legislative Guide on Insolvency Law which refers to the enforceability of close-out netting as a feature to be considered when designing corporate insolvency law and advises that close-out netting should be permitted under the applicable insolvency procedure in relation to transactions covered by financial contracts regardless of whether the termination of the contracts occurs prior to or after the commencement of insolvency proceedings.[5] The reason given is that financial transactions on financial markets reduce the potential for systemic risk that could threaten the stability of financial markets by providing certainty with respect to the rights of parties to a financial contract when one party fails to perform for reasons of insolvency. The UNCITRAL Legislative

3 EUROPEAN COMMISSION 2001 Giovannini Group First Report, 57. In a second report of the Giovannini Group, it was indicated that the EU Financial Collateral Directive removes much of the uncertainty indicated in the first Giovannini report. See EUROPEAN COMMISSION 2003 Giovannini Group Second Report, 12.

4 WORLD BANK Principles (2001), para 125 p 38.

5 UNCITRAL Legislative Guide (2004), Recommendations 7(g) & 101-107.

Guide also sets a conflict of laws rule and provides that the effects of insolvency proceedings on the rights and obligations of parties in, *inter alia*, a regulated financial market are to be governed solely by the law applicable to that market.[6]

In 2005 the World Bank coordinated the work of the UNCITRAL Legislative Guide with its own 2001 Principles to formulate a set of standards on insolvency and creditor rights[7] and published a document setting out a unified insolvency and creditor rights standard (ICR Standard) integrating the principles under both documents. The Expert Working Group of the Insolvency Creditor/Debtor Regimes Task Force of the World Bank proposed the following Standard C10.4:

> 'C10.4 Exceptions to the general rule of contract treatment in insolvency proceedings should be limited, clearly defined, and allowed only for compelling commercial, public, or social interests, such as in the following cases: […] upholding (subject to a possible short stay for a defined period) termination, netting, and close-out provisions contained in clearly defined types of financial contracts, where undue delay of such actions would, because of the type of counterparty or transaction, create risks to financial market stability […].'

In paragraph (5) of the minutes of the meeting of the Expert Group of 17 December 2014, the rationale given for this amendment is that whilst it is acknowledged that legal certainty and enforceability of contracts in accordance with their terms is critical to economic activity, it was also acknowledged that:

> '[C]ertainty alone cannot be a justification for immunizing certain types of contracts from the application of fundamental principles of insolvency law. The current international norms seek to offer a framework for providing legal certainty while recognizing the need for collective action mechanisms to allow for orderly enforcement and to ensure financial market stability.'

This appears to be a prelude to the approach taken to the treatment of close-out netting and other contractual termination provisions after the financial crisis.

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6 *Ibid.*, Recommendation 32. Wessels notes in relation to this recommendation that a balance has to be maintained between the goals pursued by the *lex concursus* and the validity and effectiveness of rights under the law of the forum. In relation to this rule, a balance is maintained between (i) the social policy considerations reflected in the commercial certainty and risk reduction for the parties, (ii) the reasonableness of permitting reliance by the parties on the law creating the rights and (iii) the necessity of protecting confidence in the system and avoiding systemic risk. He considers that the last consideration favours the protection of a country's financial stability whereas the first two are more concerned with individual interests. See WESSELS (2015), para 10419.

7 WORLD BANK Report (2005), Standard C10.1–C10.4, p 32.

3.2.2 Netting in the Aftermath of the Financial Crisis

In the aftermath of the financial crisis of 2008-2009, international regulatory fora worked on the mechanisms that would allow failing financial institutions to be resolved (without resorting to State sponsored bail-outs) while preserving financial stability.[8] At a global level, the BCBS of the BIS and the FSB formulated resolution principles, some of which are directly relevant to close-out netting. Thus, in its 2010 Report and Recommendations of the Cross-border Bank Resolution Group,[9] the BCBS notes that enforceable netting agreements serve to reduce systemic risk and enhance the resiliency of critical financial or market functions. It thus provides in Recommendation 8 of the Report that '[n]ational authorities should promote the convergence of national rules governing the enforceability of close-out netting and collateral arrangements with respect to their scope of application and legal effects across borders.' Recommendation 9 then advocates that in order not to hamper the effective implementation of resolution measures '[n]ational resolution authorities should have the legal authority to temporarily delay immediate operation of contractual early termination clauses in order to complete a transfer of certain financial market contracts to another sound financial institution' and encourages industry groups such as ISDA 'to explore a way to deal with this issue in a master agreement'.[10] The BCBS states that the limitations on the exercise of termination rights should be accompanied by certain safeguards, identified to be the following: (i) the moratorium should be restricted to a limited and clearly defined timeframe; (ii) the contracts should be transferred as a whole; (ii) the transfer can only be made to a solvent transferee; and (iv) the contractual rights are preserved in the event of any future default by the transferee.

In a similar way, the FSB recommends in its 2011 Report on Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB Key Attributes), updated in 2014, that the legal framework governing, *inter alia*, contractual netting should be clear, transparent and enforceable during

8 An important consequence of the financial crisis is the global movement for the establishment and cross-border recognition of resolution regimes. For an analysis of this movement, see HAENTJENS (2014) 257.

9 BCBS 2010 Recommendations. The set of recommendations made by the BCBS in this Report resulted from its stocktaking of legal and policy frameworks for cross-border crises resolutions and its follow-up work to identify the lessons learnt from the global financial crisis.

10 Virgós and Garcimartín state that in its 2010 Report (at p 40-42) the BCBS has established two main goals of bank resolution and netting, namely (i) a moratorium on the enforcement of early termination clauses in contracts to strengthen the effectiveness of resolution tools, with adequate safeguards for these termination clauses; and (ii) the cross-jurisdictional differences in respect of netting must not render bank resolution ineffective. The rationale for imposing a temporary stay is that unrestricted close-out netting as a result of a bank resolution might constitute a significant additional threat to the stability of the financial markets. See VIRGóS & GARCIMARTíN (2014) 152.

a crisis or resolution of firms, adding however that it should not hamper the effective implementation of resolution measures.[11] On the other hand, the IMF in its report on Resolution of Cross-Border Banks – A Proposed Framework for Enhanced Coordination of June 2010 draws attention to the fact that whilst banking resolution powers overrule ordinary private property and contractual rights in the interests of wider public interests such as financial stability, it is important that creditors' rights are adequately safeguarded, *inter alia*, by respecting and protecting netting and financial collateral arrangements, potentially subject to the temporary suspension of close-out netting rights in respect of financial contracts transferred to a solvent third party.[12] In particular, the IMF report states that where a credit institution is resolved under a special resolution framework, compensation ought to be available to creditors to ensure that they are left no worse off after the resolution than if the firm had been allowed to fail and go into liquidation.[13]

3.2.3 Private Industry Initiatives

Initiatives for the promotion of close-out netting laws have also been undertaken by associations such as UNIDROIT and ISDA. ISDA is perhaps the prime proponent for the enforceability of close-out netting provisions under national laws as this is of essential importance for the effectiveness of the ISDA master agreement and consequently for the success and growth of the derivatives market.[14] ISDA published a Model Netting Law in 1996, updated in 2002, 2006 and 2018, which may be used by national legislators

11 FSB 2011 Key Attributes, Section 4, p 10. It is important to note that resolution measures should not be hindered not only domestically, but also cross-border. Mevorach notes that 'host countries are not supposed to protect local interests and grab assets where the resolution process takes due regard of interest of all entities worldwide.' See MEVORACH (2018) 242.

12 IMF 2010 Resolution of Cross-Border Banks, p 21 & Box 7, p 22.

13 *Ibid.* 20. For a discussion on the shortcomings of the FSB Key Attributes when compared to the IMF report, see LASTRA (2015) 177.

14 According to Peeters, the widespread acceptance and use of the ISDA master agreements for OTC derivatives may have been a source of *lex mercatoria* or customary law for the eventual recognition of netting as a market process. See PEETERS (2014) 77. There are diverse views on the status of standard master agreements on close-out netting under the precepts of the *lex mercatoria*. According to Collins, in the context of international financial markets, a leading example of *lex mercatoria* is the cross-border use of the ISDA Master Agreement. The ISDA documentation is believed to provide a comprehensive system of self-regulation, and where problems arose as in the case of the Argentinian sovereign debt swaps, ISDA promptly re-wrote the documents in order to avoid perceived ambiguities. Collins, however, criticises the ISDA documentation as a source of *lex mercatoria* as it fails to take into account externalities, such as the general interest, which gives legitimation to its authority, and it also fails to take into account the *jus cogens*, namely mandatory standards of international relations and protection of human rights. See COLLINS (2011) 3, 11.

in designing their netting laws. The Model Netting Law provides principles which ensure the enforceability of bilateral close-out netting, including on a multi-branch basis, as well as the recognition of statutory temporary suspensions of the exercise of termination rights imposed by national resolution regimes.[15]

UNIDROIT first promoted the enforceability of close-out netting in its 2009 Convention on Substantive Rules for Intermediated Securities (the so-called 'Geneva Securities Convention') which (replicating the provisions of the EU Financial Collateral Directive) recommends a framework for the protection of collateral transactions, providing in its Article 33 that a close-out netting provision concluded as part of a collateral transaction may be operated notwithstanding the commencement or continuation of an insolvency proceeding in relation to the collateral provider or the collateral taker.[16] In 2013 UNIDROIT adopted a set of eight Principles on the Operation of Close-out Netting Provisions intended to provide detailed guidance in the form of minimum standards to national legislators seeking to revise or introduce national legislation on close-out netting. These Principles are designed to improve enforceability of close-out netting in particular in cross-border situations for risk management purposes.[17] The core Principles are Principles 6 and 7 which together provide for the enforceability of close-out netting provisions, both outside and within insolvency. An important exception is made in Principle 8 which incorporates the international regulatory consensus with regard to resolution principles and provides that the Principles are without prejudice to measures 'which the law of the implementing State may provide for in the context of resolution regimes for financial institutions'.

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15 ISDA 2006 Guide for Legislators; ISDA 2018 Model Netting Act.

16 UNIDROIT 2009 Convention, Articles 31(3)(j) & 33. This Convention was adopted at a diplomatic conference in Geneva on 9 October 2009. The main purpose of the Convention is to offer harmonised transnational rules for the purpose of reducing the legal risks associated with the holding of securities through intermediaries.

17 UNIDROIT 2013 Close-out Netting Principles, 6. According to Peeters, the UNIDROIT Principles are the outcome of a project that originated in an ISDA proposal dated 2008, which was reactivated in May 2010 following the financial crises. He criticises the Principles for paying little attention to the critical approaches in the legal and economic literature to close-out netting which according to the author is mainly due to the fact that the Principles are based on the international (private industry) consensus with respect to close-out netting being a main contributor to system stability and the reduction of systemic risks. See PEETERS (2014) 82. Soltysinski criticises the UNIDROIT Principles as taking into account only the freedom of contract principle but largely ignoring the important qualification that the autonomy of the parties is limited by public policy mandatory laws aimed at protecting the public interest or eliminating unfair practices. See SOLTYSINSKI (2013) 441.

3.2.4 EU Legislative Developments

From a legislative aspect, EU Member States have implemented a partly harmonised substantive legal framework for close-out netting provisions.[18] The first European attempt to address the issues raised in the Lamfalussy Report was made in the field of payment and securities settlement systems. In 1998 the EU adopted the Settlement Finality Directive which recognises and enforces the process of netting in the settlement of transfer orders in a payment system[19] for the execution of cash or securities transfer orders whose participants are credit institutions and investment firms, or EU branches of foreign credit institutions and investment firms, public authorities or publicly guaranteed undertakings, a central counterparty, a settlement agent, a clearing house or a system operator.[20] This Directive provides in Article 3 that netting operating in relation to transfer orders in a payment or securities settlement system is to be legally enforceable and binding on third parties even in the event of an insolvency proceeding, including in cases where the transfer order has been entered into the system after the moment of opening of the insolvency proceeding if the system operator can prove that it was neither aware nor should have been aware of the opening of the insolvency proceeding. This Directive aims to reduce systemic risk associated with operating and participating in payment and securities settlement systems, in particular risks associated with the insolvency of a participant in a system.[21] The Directive also provides a private international law rule which states that in the event of a participant's default, the rights and obligations in connection with the participation in a payment or securities settlement system are determined by the law governing that system and not the law governing the insolvency of the participant which must be the law of a Member State.[22]

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18 The EU lacks a comprehensive or stand-alone close-out netting regime. For a discussion of the shortcomings of the current 'dispersed' regime and a proposal for a new netting regime, see EFMLG 2004 Netting Report.

19 A system is generally defined in Article 2(a) of the Directive to consist of a formal arrangement between three or more participants (excluding the system operator of that system, a possible settlement agent, a possible central counterparty, a possible clearing house or a possible indirect participant and excluding an arrangement entered into between interoperable systems) with common rules and standardised arrangements for the clearing or execution of transfer orders between the participants designated by a Member State as covered by the Directive.

20 See Article 2(f) of the SFD.

21 This is confirmed by the European Commission in its Evaluation Report on the Directive: 'The SFD was the Community legislator's response to the concerns identified by the Committee on Payment and Securities Systems (CPSS) under the auspices of the Bank for International Settlements regarding systemic risk.' See EUROPEAN COMMISSION 2005 SFD Evaluation Report, 3.

22 See Article 9(2) of the SFD.

In 2001 the EU adopted a private international law rule on the choice of law provision in netting contracts through the Banks Winding-Up Directive. This Directive introduces the home State control principle for insolvencies of credit institutions with branches in other Member States, inspired by the principle of home State supervision initially laid down in the Second Banking Directive.[23] It originally governed only the insolvency proceedings of credit institutions, but its application has been extended to investment firms by the BRRD.[24] The Banks Winding-Up Directive provides for a number of exceptions to the principle of the application of the home Member State rules as regards the effects of reorganisation measures and winding-up proceedings. One such exception is provided in relation to set-off. Thus, whilst Article 10(2)(c) provides that the law of the home State shall determine the conditions under which set-off may be invoked, Article 23 provides that the adoption of reorganisation measures or the opening of winding-up proceedings shall not affect the right of creditors to demand set-off if the law applicable to the institution's claim allows it. Thus, the law governing set-off in insolvency is split between the *lex fori concursus* and the *lex contractus*.[25] On the other hand, outside of an insolvency situation, Article 17 of Regulation No 593/2008 on the law applicable to contractual obligations (Rome I)[26] provides that where the right to set-off is not agreed by the parties, 'set-off shall be governed by the law applicable to the claim against which the right to set-off is asserted'. In relation to netting, the Banks' Winding-up Directive stipulates in Article 25 that '[w]ithout prejudice to Articles 86 and 71 of Directive 2014/59/EU, netting agreements shall

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23 Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC, [1989] OJ L386/1.

24 See Article 117 of the BRRD. This amendment was introduced following an observation made in a 2012 Report of the European Commission that there was a lacuna in EU law for an instrument governing the cross-border insolvencies for collective investment undertakings and investment firms. See EUROPEAN COMMISSION 2012 Insolvency Report, 8.

25 For a detailed analysis of the interpretation of analogous provisions contained in the Insolvency Regulation, see VIRGóS & GARCIMARTíN (2004) 11. Wessels notes that such provisions which allow the parties to select the applicable law to the exclusion of the *lex concursus* means that parties can choose the most favourable law in terms of the effects of insolvency on their contracts which could be a non-EEA state. See WESSELS (2006) 364.

26 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), [2008] OJ L 177/6.

be governed solely by the law of the contract governing such agreements.'[27] Article 26 provides a similar rule with regard to repurchase agreements. It has been stated that the use of the word 'solely' and the comparison with the rules on set-off, in particular the lack of clarification regarding voidability and unenforceability, leads to the interpretation that this reference is to the exclusion of the insolvency law of the *forum* even if the selected governing law is that of a jurisdiction outside the EU.[28] This rule is based on the protection of party autonomy whereby the parties can choose the insolvency framework applicable to the enforceability of the close-out netting provision.[29] However, following the financial crisis, this stance was somewhat limited by the BRRD. This Article was amended in 2014 by Article 117 of the BRRD to subject this rule to the provisions of Articles 68 and 71 of the BRRD. The reference to Article 68 relates to the situation whereby the taking of any crisis prevention, suspension of obligations or crisis management measures by a resolution authority is not deemed to be an enforcement event leading to early termination of contracts, whilst Article 71 relates to the power of resolution authorities to impose a temporary stay on the

27 In the absence of a definition of netting agreement in the Banks Winding-Up Directive, there is no reason to assume that the term should not include also close-out netting agreements. See MOSS *et al.* (2017) 108. According to these authors, the reference to the *lex contractus* could also refer to the law of a non-EEA jurisdiction with the consequential disadvantages of different treatment of creditors and depositors. *Ibid.* 107. Garcimartín *et al.* note that Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings [2015] OJ L 141 (the Recast Insolvency Regulation) does not provide for a similar provision as Article 25 of the Banking Winding-up Directive but they consider that a combined reading of Article 7 and 9 of the Recast Insolvency Regulation can be broadly construed to include close-out netting within the scope of Article 9 since otherwise the result in a contractual relationship between a company and a bank it would be contradictory that the close-out netting provision is governed in accordance with the *lex contractus* only when the bank becomes insolvent. See HAENTJENS & WESSELS (2019) 208. For a detailed commentary of the EU Recast Insolvency Regulation, see WESSELS (2017).

28 See in this respect, WESSELS (2015), para 10638; PAECH (2014) 435; EFMLG 2004 Netting Report 38, 40; PEETERS (2014) 79.

29 VIRGóS & GARCIMARTíN (2014) 157; BöGER (2013) 256. In the Council's statement of reasons for the introduction of this provision, it is stated that:

> 'Such agreements are commonly used on the financial markets and the Council considers that the special function of such contracts requires a derogation from the principle of universal application of home Member State law in order to protect the functioning of the financial markets and to ensure legal certainty for the contracting parties.'

See Common Position EC No 43/2000 adopted by the Council on 17 July 2000 with a view to adopting Directive 2000/…/EC of the European Parliament and of the Council of … on the reorganisation and winding-up of credit institutions, [2000] OJ C 300/13.

exercise of termination rights under private contracts.[30] This amendment seeks to ensure that even if the law of a non-EU Member State is selected to govern the netting agreement, this does not frustrate the preventive or resolution measures of failing EU credit institutions or investment firms.[31]

This development was followed in 2002 by the issue of the Financial Collateral Directive which may be considered as the most important milestone in the harmonisation of EU close-out netting regimes. This Directive introduces an EU framework for financial collateral arrangements. It applies only to arrangements concluded between specified parties, such as credit institutions and supervised financial institutions, including a possibility for Member States to extend the application to companies concluding a financial collateral arrangement with the former. The financial collateral must be provided and should be evidenced in writing. Article 7 of the Financial Collateral Directive provides that Member States shall ensure that a close-out netting provision can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of either of the parties and notwithstanding any purported assignment, judicial or other attachment or disposition. Member States are further obliged to ensure that the operation of a close-out netting provision is not subject to certain requirements, such as prior notice and official approval, unless otherwise agreed by the parties.

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30 It has been stated that this amendment does not avert all ambiguity since in order to protect the exercise of resolution powers, the amendments should have extended protection also to the *lex resolutionis* in relation to Articles 69 and 71 regarding the resolution authorities' powers to suspend certain obligations and to restrict the enforcement of security interests as well as Article 49 on the exercise of the bail-in power in relation to derivatives. See Francisco Garcimartín, 'Resolution Tools and Derivatives', in HAENTJENS & WESSELS (2014) 193.

31 No similar clause on the governing law of netting agreements exists in either the EU Recast Insolvency Regulation governing insolvency proceedings of non-supervised institutions or in the Solvency II Recast Directive (Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) (recast) [2009] OJ L 335/1) in relation to insurance undertakings. In the absence of specific rules on governing law on netting arrangements, it is presumed that in case of both Solvency II and the Recast Insolvency Regulation the general rules apply, referring the question of enforceability of close-out netting to the *forum* law. The predecessors of these legal acts, Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, [2000] OJ L 160/1, and, insofar as concerns the relevant parts on insolvency proceedings of cross-border insurance undertakings, Council Directive 2001/17/EC of 19 March 2001 of the European Parliament and of the Council on the reorganisation and winding-up of insurance undertakings, [2001] OJ L 110/28, also did not contain provisions on the governing law of netting agreements, although one draft version of the EU Recast Insolvency Regulation did contain a provision similar to Article 25 of the Banks Winding-Up Directive. This provision was dropped in the final version of this recast Regulation. See Article 9 of the Recast Insolvency Regulation and Article 288 of the Insolvency II (Recast) Directive.

The recommendations of the BCBS and FSB on the effective implementation of resolution measures in the banking sector have been implemented by the adoption in 2014 of the EU Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation.[32] Both the Directive and the Regulation determine the rules how failing credit institutions and certain investment firms are restructured and how losses and costs are allocated to the failing institution's shareholders and creditors. However, whilst the Directive relies on a network of national authorities and resolution funds to resolve an institution, the Regulation provides for a central decision-making process (mainly through the Single Resolution Board) to ensure that resolution decisions in respect of institutions supervised under the Single Supervision Mechanism (SSM)[33] are taken effectively, avoiding uncoordinated action.[34] This EU resolution regime, whilst safeguarding the effectiveness of resolution measures from termination rights granted to creditors under financial contracts, also seeks to protect the integrity of close-out netting provisions. Thus, resolution authorities are empowered to suspend the exercise of contractual termination rights until midnight of the day following the publication of a notice of the adoption of resolution measures to enable them to decide on specific resolution actions, e.g. to transfer all the obligations subject to a close-out netting provision to a solvent bridge institution, and to put the necessary measures into effect. This is intended to stall the possibility of a counterparty run and the fire sales of its assets, effectively preserving the viability of the failing institution and enabling its orderly resolution. However, this EU regime makes it mandatory on the resolution authorities that if they decide to transfer the obligations to another entity, they can only transfer in whole, or not at all, the obligations covered by a close-out netting provision.

32 As noted in the Introduction, both legal acts have been amended by so-called the BRRD II Directive and the SRM II Regulation. The latter will apply from 28 December 2020.

33 The Single Supervisory Mechanism (SSM) is the name for the mechanism which has granted the European Central Bank a supervisory role to monitor the financial stability of significant credit institutions based in euro area Member States starting from 4 November 2014. Member States outside the euro area may also voluntarily participate. The SSM is the first pillar of the EU Banking Union and will function in conjunction with the Single Resolution Mechanism (SRM) and a Single Resolution Fund. See Council Regulation (EU) No. 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, [2013] OJ L 287/63.

34 Resolution decisions are taken centrally by the Single Resolution Board (SRB) to ensure a coherent and uniform approach of the resolution rules. The SRB also monitors the execution by the national resolution authorities of its decisions at national level. The SRB will apply the Single Rulebook on bank resolution provided in the Bank Recovery and Resolution Directive in the euro area Member States just as this is applied by national resolution authorities in the other Member States. As regards the relationship between the SRM Regulation and the Bank Recovery and Resolution Directive, see Articles 5 and 29 of the SRM Regulation.

3.3 The Regulation of Close-out Netting Provisions under EU Law

Arguably the Financial Collateral Directive and the Bank Recovery and Resolution Directive are the two EU legal acts to have mostly influenced the development of substantive national law on bilateral close-out netting provisions for diverse reasons. The first was instrumental in harmonising to a large degree the laws of Member States on the recognition of close-out netting provisions forming part of a financial collateral arrangement. In fact, it has been seen earlier in this chapter that the FCD solved most of the problems indicated in Barrier 14 of the first Giovannini Report in relation to clearing and settlement arrangements. The second aimed to ensure that the exercise of close-out netting rights does not frustrate the resolution of important banking institutions in pursuance of the goal of financial stability. The effect on the development of close-out netting of each of these legal acts is analysed in more detail below.

3.3.1 The Financial Collateral Directive

The Financial Collateral Directive implements part of the European Commission's Financial Services Action Plan[35] and is based on Article 114 of the Treaty on the Functioning of the European Union, formerly Article 95 of the Treaty establishing the European Community. Article 114(1) empowers the Council and the European Parliament, acting in accordance with the ordinary legislative procedure, to adopt measures for the approximation of laws to achieve the objectives of Article 26. Article 26 provides for the establishment and functioning of the internal market. The scope of this Directive is therefore shaped by considerations of promoting the single market. In terms of the principle of proportionality, the Directive does not go beyond a minimum regime relating to the use of financial collateral which cannot be sufficiently achieved by Member States.[36]

The Directive aims to achieve legal certainty for financial collateral arrangements by ensuring that national insolvency law provisions do not apply to such arrangements, in particular so as not to frustrate the effective realisation of financial collateral or question the enforceability of certain techniques such as bilateral close-out netting and the provision of additional

35 EUROPEAN COMMISSION 1999 Action Plan. The Directive complements the Commission's wide-ranging efforts in the context of the Financial Services Action Plan to encourage cross-border business in financial services, secure the full benefits of the single currency and develop an optimally functioning European financial market.

36 See Recital (22). For an overview of the implementation of the Financial Collateral Directive by Member States see LöBER & KLIMA (2006); EFMLG 2005 Close-out Netting Regulation.

collateral in the form of top-up collateral and substitution of collateral.[37] This is a clear indication that at the time the Directive was adopted, considerations of efficiency and party autonomy in the design and recognition of financial collateral arrangements were foremost in the mind of the EU legislator and it was readily assumed that insolvency law provisions should not be allowed to interfere with the enforceability of financial collateral arrangements 'in accordance with their terms'.[38] The rapid enforceability of procedures was, at the time of adoption, deemed by the EU legislator necessary to safeguard financial stability and limit contagion effects in case of a default of a party to a financial collateral arrangement.[39] It is apparent that the notion of financial stability envisaged by this Directive favours the solvent counterparty who is enabled to enforce its individual claims upon the insolvency of the other party.

In terms of its personal and material scope, the Directive falls squarely in the domain of the financial markets in conformity with the objective of the Directive to establish stability in the financial sector. Thus, Article 1 of the Directive establishes a regime applicable to financial collateral arrangements where the parties include public authorities, central banks, credit and financial institutions, investment firms, insurance undertakings, central counterparties and other related entities. At the option of Member States, the regime can be extended to persons other than natural persons, including unincorporated firms and partnerships, provided that the other party to the arrangement is an institution as stipulated above. Thus, the Directive excludes natural persons from its personal scope. In terms of the material scope of the Directive, it is stated in Article 1(5) that the Directive applies to financial collateral arrangements defined in Article 2(1)(a) as a title transfer type of arrangement such as a repo or a security type of arrangement such as a pledge. In terms of Article 1(4), the financial collateral must consist

37 See Recital (5). Prior to the Directive, only collateral provided to a central bank or in combination with participation in a designated system enjoyed protection under Article 9 of the Settlement Finality Directive. In a memo of the European Commission of 30 March 2001, the Commission explained that the Directive aims to overcome differences in Member States own legal traditions, in particular as regards insolvency law and perfection and realisation of collateral. For participants in the EU financial market this means having to adjust to a different set of rules for each Member State in which they do business, which is costly and problematic. See EUROPEAN COMMISSION 2001 FAQs, 2.

38 This is confirmed by Article 4(5) of the Directive.

39 See Recital (17). This Recital, however, also foresees that the rights of the collateral provider and third parties should continue to be protected and Member States should keep a posteriori judicial control and provision of judicial remedies in relation to the realisation and valuation of financial collateral and the calculation of financial obligations.

of cash,[40] financial instruments or credit claims. Cash consists of money credited to an account in any currency or similar claims for the repayment of money such as money market deposits. Financial instruments refer to shares, negotiable bonds or securities giving rights to acquire such shares or bonds. Credit claims refer to bank loans. The financial obligations that are secured by a financial collateral arrangement may consist of present or future, actual or contingent or prospective obligations, including obligations arising under master agreements and similar arrangements.

3.3.1.1 Regulation of Close-out Netting Provisions

Close-out netting is regulated by Article 7 of the Financial Collateral Directive. This provision applies within the confines of the material and personal scope of the Directive described above. Article 2(1)(n) defines a close-out netting provision as a provision of a financial collateral arrangement or of an arrangement of which a financial collateral arrangement forms part. This provision is to be interpreted within the confines of the personal and material scope of the FCD. In *Private Equity Insurance Group SIA v Swedbank AS*[41] the European Court of Justice adopted a narrow interpretation of the material scope and held that the FCD 'is applicable *rationae materiae* only if the collateral is provided and, in order for it to be so applicable, subject to Article 8(2) of this directive, that the collateral be provided before the commencement of insolvency proceedings'.[42] It would thus appear that a close-out netting provision must form part of a financial collateral arrangement or be related to it in cases where the collateral has been provided, interpreted in the same preliminary ruling to instances where the collateral-giver has been dispossessed of that collateral or is otherwise prevented from disposing of it.[43]

Recital (14) stipulates that close-out netting provisions are being protected under the Directive as they enable market participants 'to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty [...]'. It is evident that the primary scope for protecting

40 In *Private Equity Insurance Group SIA v Swedbank AS* [2016] C-156/15, the European Court of Justice held in a preliminary ruling that the FCD incorporates a wide definition of cash which is not limited to cash deposited in an account used in securities payment and settlement systems even though the FCD originated as a further measure to the Settlement Finality Directive. On the other hand, the court gave a restrictive interpretation of the requirement in Article 2(2) of the FCD that the financial collateral be provided 'so as to be in the possession or under the control of the collateral taker' and held that some form of dispossession is required to ensure that the collateral taker is actually in a position to dispose of the collateral when an enforcement event occurs.

41 [2016] C-156/15.

42 *Ibid.* para 52.

43 *Ibid.* para 44.

close-out netting provisions under the Financial Collateral Directive is to safeguard their risk mitigation function. The approach is therefore inclined towards the protection of the private benefits accruing to parties of a close-out netting agreement.

Article 7 postulates a close-out netting protection clause which, at first glance, appears to grant full recognition to contractual freedom in the formulation and enforceability of close-out netting provisions. Article 7 obliges Member States to ensure that close-out netting provisions can take effect in accordance with their terms notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of either of its parties and notwithstanding any purported assignment, judicial or other attachment or other disposition in respect of such rights. In order for a close-out netting to be effective in its own terms it is important that the provision is drafted so as to provide clearly for those events which will trigger its applicability.

Article 8 then protects financial collateral arrangements (including a close-out netting provision) which come into existence on the day of, but after the moment of the commencement of, winding-up proceedings or reorganisation measures if the collateral taker can prove that he was not aware, nor should have been aware, of the commencement of such proceedings or measures.[44] This provision protects close-out netting provisions from suspect periods and zero-hour rules. According to Keijser, the burden of proof lies with the counterparty of the insolvent party. It will be almost impossible to prove this once the information about the insolvency becomes publicly available, because it is assumed that a counterparty ought to have known about it. There may be a timeframe in national law between the declaration of the opening of insolvency proceedings by the court and the actual publication of those proceedings where it could be presumed that the counterparty was acting in good faith. Still, it may be possible for the counterparty to have known from other sources, for instance through published financial statements of the failing debtor.[45]

The Financial Collateral Directive recognises certain limitations which may be imposed under national law when granting recognition to close-out netting provisions. One reference is made in Article 4(6) which provides that Article 7 is without prejudice to any requirements under national law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commer-

44 Paech comments that this provision leaves a number of implementation options to Member States since the relevant applicable criteria such as the definition of 'knowledge' may differ depending on the jurisdiction, as there is no harmonised, exhaustive definition of relevant criteria. Paech states that it may be unclear whether the judge of the *forum* will apply the reservations prescribed by the *forum* law even if the law applicable to the relevant close-out netting agreement is foreign. See PAECH (2014) 442.

45 KEIJSER (2006) 324.

cially reasonable manner. According to Peeters, this requirement would, in general, be already set in the close-out netting provision concluded between the parties, in particular if the parties have resorted to a master agreement and should therefore not constitute an additional obstacle to the party autonomy principle.[46] What is perhaps not clear is whether national law setting other obligations on the parties how to calculate the relevant financial obligations, e.g. the time of the valuation of the collateral, would also have to be observed. This may be contemplated under Recital (15) which provides that the Directive is without prejudice to any restrictions or requirements under national law on bringing into account claims, on obligations to set-off or on netting, for example relating to their reciprocity or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement (or of any mandatory legal act leading to the commencement) of winding-up proceedings or reorganisation measures in respect of the collateral provider.[47]

As a result of these provisions, it has been stated that the Financial Collateral Directive does not offer complete certainty in the close-out netting provisions falling under its scope of application.[48] According to Keijser, an important issue which is not regulated by the Financial Collateral Directive regards the moment in time at which the claims of the parties who are subject to close-out should be valued and as such this issue should be determined under national law. It can be argued, however, that if the main rule under Article 7(1) is that close-out netting provisions should be regulated 'in accordance with their terms', the EU legislator intended to give contractual freedom to the parties to establish matters not covered by the Directive. Hence, in the absence of a mandatory rule under national law, it is expected that this issue is also determined by the contractual freedom of the parties.[49] National law can impose various mandatory conditions such as the mutuality or reciprocity of the obligations subject to close-out netting. It is equally possible that national law has a say on the issue whether a claim comes into existence prior to the moment that the insolvent party's counterparty came to know or ought to have known of the insolvency, or after that moment. This would be the case of rules on voidable preferences which aim to restrain giving a creditor a preferential position to the detriment of all

46 PEETERS (2014) 80.

47 According to Paech, Recital (15) recognises the concerns of national policy makers on losing control over national policies regarding the relationship of the insolvent estate with its creditors, in particular on the scope of the close-out netting provision in relation to the *pari passu* principle notably by defining details of the scope of avoidance and similar powers of the insolvency practitioner or insolvency court. See PAECH 2014 449.

48 KEIJSER (2006) 292.

49 *Ibid.* 293.

other creditors.[50] On the other hand, it is uncertain whether Recital (15) may allow national law to impose requirements that the obligations being netted must be of the same kind. Thus, would national law determine whether cash and securities can be netted out under a repo or a securities lending contract. Keijser is of the opinion that to allow this to be determined by national law would go against the general aim of Recital (14) and Article 7 which are intended to guarantee the enforceability of close-out netting provisions in contracts that relate to cash and different kinds of securities such as a repo agreement.[51] However, it is arguably doubtful whether these provisions of the Financial Collateral Directive can be so widely interpreted as to cover instances of cross-product netting arising under master master netting agreements such as the Cross-Product Netting Master Agreement which may go beyond the confines of this Directive.[52]

A significant change in relation to the recognition granted to close-out netting provisions has been brought into effect by the BRRD in 2014. Article 118 of this latter Directive amends the Financial Collateral Directive by adding a new paragraph to Article 1 which provides that Articles 4 to 7 are disapplied in relation to any restriction on the enforcement of financial collateral arrangements or any restriction on the effect of a security financial collateral arrangement, any close-out netting or set-off provision imposed under the BRRD or to similar restrictions imposed under the laws of Member States to facilitate the orderly resolution of supervised entities. The BRRD also amends Article 9a to provide that the Financial Collateral Directive is without prejudice, *inter alia*, to the provisions of the BRRD. The effect of these amendments is to subordinate the application of the provisions of the Financial Collateral Directive to those of the BRRD.[53] The implications of this in relation to party autonomy and close-out netting will be analysed below.

3.3.2 The Bank Recovery and Resolution Directive

Following the financial crisis of 2008 and 2009, banking regulators and legislators recognised that established insolvency law procedures do not provide the tools needed to manage financial difficulties affecting complex banking

50 This reference in Recital (15) to rules of national law reflects the approach taken in Recital (16) and Article 8(4) of the Financial Collateral Directive which also refer to general rules of national insolvency law relating to voidance of transactions which were entered into during a prescribed period before insolvency and are to the detriment of the other creditors.

51 See KEIJSER (2006) 303.

52 For instance, the Financial Collateral Directive does not appear to cover instances where deposits may be netted against repo agreements. Moreover, in most instances master master netting agreements may not form part of a financial collateral arrangement, even in the wider meaning of this clause.

53 According to Sumpter and Blundell, the effect of this subordination of laws is that on the exercise of BRRD resolution powers only those safeguards and protections under the BRRD will be available, and not those under the FCD. See SUMPTER & BLUNDELL (2016) 82.

organisations. In response to this need, the Single Resolution Mechanism Regulation and the Bank Recovery and Resolution Directive establish a common EU framework of rules and powers for regulators to intervene and manage credit institutions in difficulty. This framework is intended to achieve five objectives, namely ensuring the continuity of critical functions, avoiding financial instability and maintaining market discipline, protecting public funds by minimising reliance on public financial support, protecting depositors and investors, and protecting client funds and client assets.[54] In order to achieve these objectives, the BRRD provides for resolution tools which include the sale of business to a third party, the powers to set up a bridge institution to hold the business of the institution pending a sale to a third party, a power to separate assets (into good and bad assets) and transfer them into two or more vehicles, and bail-in, *i.e.* the write-down and conversion powers in relation to liabilities in accordance with Article 43 of the BRRD.[55]

Similar to the Financial Collateral Directive, the legal base of the BRRD is Article 114 of the Treaty on the Functioning of the European Union dealing with the approximation of laws intended to achieve the objectives of the establishment and functioning of the internal market. The BRRD applies to credit institutions and investment firms including their branches established outside the EU, financial holding companies, mixed financial holding companies, mixed-activity holding companies and their subsidiary financial institutions.[56] In general terms, the BRRD interferes with close-out netting provisions in two ways. First it gives resolution authorities the statutory powers to trigger the application of those provisions in order to apply the bail-in tool in relation to derivatives. Second, it excludes or delays the rights of the counterparty to trigger the application of those provisions in order to enhance the effectiveness of other resolution tools, such as the transfer of business. These powers granted to resolution authorities are counterbalanced by important safeguards. One important safeguard is specified in Recital (95) of the BRRD which states that in order to preserve legitimate

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54 See Article 31(2) of the BRRD. It may not be possible to meet all objectives when exercising resolution powers. Thus, it may not be feasible to protect depositors without recourse to public funds. The resolution authority's task is therefore to balance competing objectives by means of subjective judgments. See KING & WOOD (2013) 641.

55 See Article 37(3) of the BRRD. In terms of Article 32(1) of the BRRD, resolution powers can only be used if all of the following conditions are met: (i) the institution is failing or is likely to fail, defined under Article 32(4) to include not only traditional insolvency standards such as inability to pay debts as they fall due and balance sheet insolvency, but also failure to maintain sufficient regulatory capital and a situation where public financial support is needed to prevent serious disturbance to the economy of a Member State or to preserve financial stability; (ii) there is no reasonable prospect that any other action, including the use of the regulator's powers, would avoid failure; and (iii) resolution action is necessary in the public interest.

56 See Article 1(1)(a) to (e) of the BRRD.

capital market arrangements in the event of the transfer of some, but not all, of the assets, rights and liabilities of a failing institution, it is appropriate to include safeguards to prevent the splitting of linked liabilities, rights and contracts with the same counterparty covered by *inter alia* close-out netting agreements so that resolution authorities are bound to transfer all linked contracts within a protected arrangement or leave them all with the residual failing institution. The balance sought to be achieved by the BRRD between on the one hand, protecting the effectiveness of resolution measures in order to safeguard financial stability and, on the other, preserving the reliability of, and risk mitigation factor attained through, close-out netting, will be examined below.

3.3.2.1 Limitations on the Exercise of Close-out Netting Rights

It appears to have been the intention of the EU legislator to capture all possible configurations of netting arrangements (*i.e* not only those foreseen in the Settlement Finality Directive and the Financial Collateral Directive) to ensure the effectiveness of resolution measures. This is apparent in the wide definition of 'netting arrangement' provided in point (98) of Article 2(1) of the BRRD which includes a number of netting possibilities. The term 'arrangement' itself denotes both formal contractual situations and less informal arrangements agreed or applicable between counterparties.

There are a number of provisions in the BRRD which, directly or indirectly, affect or relate to the three constitutive elements of close-out netting, namely termination, valuation and determination of a net balance. The first such provision is Article 49 on the exercise of the write-down and conversion tool (*i.e.* the bail-in tool)[57] in relation to derivatives. This Article gives power to the resolution authority to itself exercise the termination and valuation rights under existing close-out netting agreements.[58] Article 49 aims to allow resolution authorities to freely exercise the write-down and

57 The bail-in tool, as opposed to bail-out, means that losses suffered by a distressed institution are not paid by taxpayers but by its shareholders or other stakeholders such as creditors. The bail-in tool, which should meet the conditions of Articles 43 and 44 of the BRRD, is said to satisfy a double test: (i) it must respect, as far as possible, the insolvency statutory order of priorities and the *pari passu* treatment of creditors, and (ii) it must leave no creditor worse off than if the failed entity had gone into formal insolvency proceedings.

58 The BRRD gives power to the resolution authority to extend the list of liabilities excluded from bail-in on a case-by-case basis on the grounds listed in Article 44(3) which includes the prevention of a severe disruption of financial markets. Thus, when the scope of financial stability is best served by preserving the derivatives business of a failing institution, resolution authorities are expected not to exercise bail-in in respect of derivatives. The power of exclusion is to be exercised 'in exceptional circumstances' and when this is 'strictly necessary and proportionate' to achieve the continuity of critical functions and core business.

conversion powers in relation to derivatives[59] but at the same time sets out two safeguards in favour of close-out netting arrangements.

First, the resolution authorities may exercise these powers only upon or after the closing-out of the derivatives. This protects the single agreement concept of most netting agreements, in particular master agreements, and thus aims to protect the 'all-or-nothing' approach in relation to linked liabilities in a close-out netting agreement in order to protect the determination of the net balance element. It also protects the management of risk exposure sought to be achieved in netting agreements. Moreover, it is only upon closing out that the resolution authority can determine whether a derivative contract gives rise to a liability and what is its exact amount.[60] The resolution authority is thus given power to itself exercise the right to terminate a close-out netting agreement since it is presumed that the solvent counterparty may be reluctant to do so if it stands to lose from the close-out or if the resolution measure does not trigger the close-out mechanism under the agreement as, in terms of the provisions of the BRRD, it is not a trigger event.

Second, this Article protects the valuation clauses of netting arrangements and provides that where derivative transactions are subject to a netting agreement, their valuation shall be determined by the resolution authority or an independent valuer 'on a net basis in accordance with the terms of the netting agreement'. It is clear that the EU legislator has attempted, to the extent possible, to preserve the terms imposed by the netting agreement and to retain intact the netting mechanism insofar as regards valuation of derivatives as stipulated under the netting agreement. Even the European Banking Authority (EBA),[61] when exercising its delegated powers under this Article to adopt regulatory standards specifying methodologies on the valuation of derivatives, is to take into account the methodology for close-out set out in any relevant netting agreement. Perhaps what is not clear is what happens in those instances where national law (referring to both the *lex resolutionis* and the *lex contractus*) imposes conditions on the valuation of derivatives under a netting arrangement.

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59 In fact, this provision has been criticised as only providing generalised principles, leaving a substantial degree of discretion to resolution authorities, which may not be conducive to a level playing field in the exercise of this resolution tool. See Victor de Serière, 'Bail-in: Some Fundamental Questions', in HAENTJENS & WESSELS (2014) 171.

60 This is the case since the application of bail-in powers to derivatives may only be conceived when the failing institution is 'out-of-the-money'. See Francisco Garcimartín, 'Resolution Tools and Derivatives', in HAENTJENS & WESSELS (2014) 187.

61 The EBA was established on 1 January 2011 to form part of the European System of Financial Supervision with the main task of contributing to the creation of the European Single Rulebook in banking. It promotes convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector. See the EBA's website at <http://www.eba.europa.eu/>.

Whilst it has been discussed above that the Financial Collateral Directive may be interpreted to give precedence to national law in this matter, the BRRD does not contemplate this situation but refers only to the valuation clauses of the netting agreement.[62]

A second provision affecting the exercise of close-out netting rights is Article 68 of the BRRD which affects the trigger aspect of close-out netting provisions required to initiate the termination phase. Since one of the objectives of resolution regimes is to protect viable parts of an institution under resolution, such regimes must deal with rights of the institution's counterparties to terminate financial contracts. The continuing operation of these contracts may be essential for the viability of the institution's business that resolution measures are seeking to preserve, in particular if they are critical functions of the institution.[63] This Article first regulates the relationship between the BRRD with the netting provisions of the Settlement Finality Directive and the Financial Collateral Directive by providing that a crisis prevention measure, a suspension of payment or delivery obligations,[64] or a crisis management measure taken in relation to an entity under the Directive does not constitute an enforcement event within the meaning of the Financial Collateral Directive or insolvency proceedings within the meaning of the Settlement Finality Directive if substantive obligations under the relevant contract (such as payment or delivery obligations and the provision of collateral) continue to be performed. The effect of this provision is to ensure the continuation of business in relation to payments and security settlement systems and the non-termination of financial collateral arrangements pending any resolution measures to be taken by resolution authorities.

In the same vein, Article 68(3) of the BRRD provides that a crisis prevention measure, a suspension of obligations or a crisis management measure shall not *ipso facto* make it possible for any party to an agreement to exercise, *inter alia*, any termination, netting or set-off rights, if the substantive obligations under the agreement continue to be performed and is intended to protect the implementation of resolution measures aimed at achieving the continuity of the failing institution or the transfer to a bridge bank or a third party. This clause does not affect the exercise of these rights when this is

62 Commission Delegated Regulation (EU) 2016/1401 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principle on the valuation of liabilities arising from derivatives, [2016] OJ L 228/7, sets the rules for the valuation of derivatives contracts, in particular in Article 2. In terms of Article 4 of this Commission Delegated Regulation, for contracts subject to a netting agreement, the single amount shall be determined as defined in the netting agreement.

63 KEIJSER *et al.* (2014) 51.

64 The reference to suspension of obligations in Article 68 if the BRRD was added by Article 1(29) of the BRRD II and constitutes a reference to suspension which may be exercised by resolution authorities under Article 33a of the BRRD.

triggered by events which are not related to the exercise of crisis prevention measures or crisis management measures. This provision applies as a mandatory rule within the meaning of Article 9 of the Rome I Regulation[65] and as a result will apply irrespective of the law governing the netting agreement. Otherwise, by choosing a foreign law, it would be relatively easy for the parties to avoid the application of these powers.[66] This has the effect that a court in an EU Member State is bound to reject the parties' characterisation of a resolution measure as a contractual enforcement event in their contract, notwithstanding that the applicable law of the contract is the law of a third non-EU country. It does not, however, eliminate the risk of incompatible parallel judgments in cases where the resolution forum is an EU Member State and the solvent counterparty brings an action to enforce contractual termination provisions in the court of the third country.[67]

A third provision affecting close-out netting is Article 71 of the BRRD. This Article goes a step further than Article 68 and empowers resolution authorities to temporarily suspend termination rights under a contract with an institution under resolution from the publication of the notice of the resolution action until midnight of the business day following this publication, provided that payment and delivery obligations continue to be performed. This is intended to allow the resolution authority a timeframe within which to decide whether to transfer the obligations covered by the netting agreement to a bridge institution. The temporary suspension, which cannot be extended, is accompanied by certain safeguards. First, during that period, the payment and delivery obligations of the solvent counterparties are also suspended and only become due immediately upon expiry of the suspension period, and, second, the BRRD explicitly provides that the

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65 Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (Rome I), [2008] OJ L 177/6. Article 9 provides, *inter alia*, that provisions regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, are applicable to any situation falling within their scope, irrespective of any contractual governing law.

66 As already seen above, this is reinforced by an amendment to Article 25 of the Banks Winding-Up Directive which provides that the effects of entry into resolution, restructuring or winding-up proceedings on netting agreements will be governed by the law applicable to those agreements, but without prejudice to Article 68 of the BRRD on the general exclusion of the entry into resolution as a termination event and Article 71 on the power to temporarily suspend contractual termination rights. The same amendment has been affected to Article 26 of the Banks Winding-Up Directive in relation to the law applicable to repo agreements.

67 The FSB has expressed a concern that given the cross-border nature of financial relationships where the governing law of the contracts will be a foreign law at least for one of the counterparties, national courts may not be able to enforce a restriction or temporary stay on the exercise of early termination rights imposed under a foreign resolution regime, where the contract in question is governed by the law of the court's jurisdiction or would be unlikely to do so sufficiently promptly to meet the needs of effective resolution. It is therefore important that the restrictions on contractual rights can be enforced across borders. See FSB 2014 Consultative Document, 3.

obligations of the institution under resolution will become due immediately upon expiry of the suspension period.[68] In order to ensure the effectiveness of these measures, the BRRD gives resolution authorities an equivalent power of suspension that may be invoked in respect of the enforcement of security interests.[69]

This Article provides for the following exceptions or qualifications to the temporary suspension of termination rights:

(a) In order to protect the finality of transfer orders in a payment or securities settlement system, this Article provides that the suspension of termination rights does not apply to systems or operators of systems designated for the purposes of the Settlement Finality Directive, central counterparties or central banks.[70] Otherwise, there could result a major liquidity problem in ensuring overall settlement on the business day affected.

(b) A counterparty may exercise termination rights under a contract before the end of the suspension period if it receives notice from the resolution authority that the rights and liabilities covered by the contract shall, in fact, not be transferred to another entity neither will they be subject to the write down or conversion tool.[71]

(c) In the event of a transfer of contractual rights and liabilities, termination rights may be exercised at the end of the expiry of the suspension period, subject to the provisions of Article 68,[72] only on the occurrence of any continuing or subsequent enforcement event by the transferee entity.[73] This assures the new acquirer that those contracts will not be immediately terminated after the transfer.

(d) If the contractual rights and liabilities remain with the institution under resolution and the resolution authority has not exercised the write down or conversion tools, the counterparty may proceed to exercise termination rights under the terms of the contract at the end of the expiry of the suspension period.[74]

A visible effort has been made by the EU legislator to safeguard the close-out netting mechanism of financial contracts and to interfere only in a way which is strictly necessary for the effectiveness of resolution measures. A further consideration is taken into account in Article 71(6) which imposes an obligation on resolution authorities to have regard to the impact of the

68 See Article 69 of the BRRD.
69 See Article 70 of the BRRD.
70 See Article 71(3) of the BRRD.
71 See Article 71(4) of the BRRD.
72 The link with Article 68 of the BRRD presumably refers to the mandatory rule that the taking of resolution action in itself cannot *ipso facto* lead to triggering the termination of the netting agreement.
73 See Article 71(5)(a) of the BRRD.
74 See Article 71(5)(b) of the BRRD.

exercise of imposing a temporary suspension on the orderly functioning of the financial markets. Thus, there is a clear understanding that the exercise of powers is not absolute and a balancing of interests has to take place continuously.

The BRRD grants further protection to netting agreements under the provisions of Articles 76 to 80. Article 76 imposes an obligation on Member States to safeguard a number of arrangements, including netting arrangements, the details of which are further specified in Articles 77 to 80. Of relevance to netting arrangements is Article 77 which prohibits the transfer of some, but not all, of the rights and liabilities that are protected under, *inter alia*, a netting arrangement between the institution under resolution and its counterparties. This is complemented by Article 78 which provides that the transfer of secured obligations is legally ineffective unless the related security arrangements, together with the security assets, are also transferred to the new entity. Article 77 also prohibits the modification or termination of rights and liabilities protected under a netting arrangement. This Article explains that rights and liabilities are to be treated as protected under such an arrangement if parties are entitled to set-off or net those rights and liabilities. An exception arises in respect of deposits covered by a national deposit guarantee scheme which may be extracted by the resolution authority from the rest of the assets, rights and liabilities to ensure their availability for regulatory purposes. In the context of payment and securities settlement systems, Article 80 provides that no transfer of assets or exercise of power by a resolution authority to cancel or modify the terms of a contract which would result in the modification or unenforceability of netting under the Settlement Finality Directive.[75]

75 Commission Delegated Regulation (EU) No 2017/867 of 7 February 2017 on classes of arrangements to be protected in a partial property transfer under Article 76 of Directive 2014/59/EU of the European Parliament and of the Council, [2017] OJ L 131/15, provides in Article 4(1) that (similar to set-off arrangements and security arrangements) bilateral netting arrangements will qualify for protection under Article 76 of the BRRD where they relate to 'rights and liabilities arising under financial contracts or derivatives' and Article 5(2) empowers resolution authorities to exclude from the protection afforded by Article 76(1) of the BRRD arrangements which permit the solvent party to make limited payments or no payments (such as a walk-away clause) to the insolvent party. Article 4 reflects the Technical Advice by the European Banking Authority on classes of arrangements to be protected in a partial property transfer of 14 August 2015 (EBA/Op/2015/15) to the European Commission stating that so called 'catch-all' or 'sweep-up' arrangements would jeopardise the efficiency and feasibility of partial property transfer powers if such arrangements are protected in accordance with their terms when they provide for the set-off or netting of all rights between the parties. *Ibid.* para 10. The national law of Member States implementing the BRRD needs to be interpreted in the light of these restrictions imposed by the Commission Delegated Regulation.

It is evident that the BRRD has put in place a number of safeguards to protect the close-out netting provision. The write down or conversion powers of derivatives covered by netting arrangements may only be exercised in relation to the net position under these arrangements and by using the valuation foreseen in the netting arrangement. The power to suspend the exercise of close-out netting rights only applies if all payment and delivery obligations continue to be performed. The suspension is brief and may only extend until midnight of the following business day. If the transactions covered by the close-out netting provision are actually transferred to a third entity, the resolution authority may not 'cherry-pick' and has to transfer all or none of the transactions. The netting counterparty is free to terminate the transactions if the transferee entity fails to perform the payment or delivery obligations under the netting agreement. In the end, the netting counterparty may find itself in a better position if the transfer takes place since it is presumably dealing with a healthier entity and it may retain its existing hedging positions.

3.4 Preliminary Conclusions

This chapter provided an overview of the sources of the *lex mercatoria* deemed to have strengthened the global recognition of close-out netting and, as a result, to have influenced the development of national close-out netting regimes. Two main sources have been identified, namely the declarations made by international regulatory bodies on the advantages of establishing the legal soundness of close-out netting provisions for the stability of financial systems and the standard market agreements of private market associations, in particular in the derivatives industry, which depended on the enforceability of their close-out netting provisions for the growth of their industry.

Prior to the financial crisis both sources were advocating the protection of close-out netting provisions in accordance with their terms and were generally in agreement in their approach that insolvency law should not hinder whatsoever the enforceability of close-out netting provisions in order to enhance the stability of the financial system. Following the financial crisis, the international regulatory bodies took the lead in issuing declarations on the need to curb the favourable treatment given to close-out netting provisions upon insolvency in relation to failing banking institutions. These bodies advocated the imposition of restrictions on the exercise of close-out netting rights to enable resolution authorities to effectively exercise bank resolution measures as this was deemed necessary for financial stability purposes. One main restriction advocated by these bodies was the temporary suspension of the exercise of contractual termination rights intended to allow national authorities to transfer the assets and liabilities of the institution in resolution. Gradually, the private industry started taking action to implement these declarations such as ISDA which adopted resolution stay protocols.[76]

EU law has been designated as a third, special source of the *lex mercatoria*. Whilst this third source will have invariably influenced the development of Member State laws, it is not excluded that it could have also influenced third country laws which, for various reasons, resorted to the EU model as a basis for their netting regimes. The regulation of netting under EU law has developed in a piecemeal manner and is mainly centred on the protection of netting from national insolvency laws. Both the Settlement Finality Directive and the Financial Collateral Directive provide for the enforceability of netting notwithstanding the commencement of insolvency proceedings against a participant or a counterparty, even if the enforcement takes place after the commencement of insolvency proceedings provided this was done in good faith. The Banks Winding-Up Directive, on the other hand, sets out a private international law rule on netting agreements which takes the form of a carve-out from the home State principle on which the Directive is based. According to the rule in this Directive, netting agreements are to be governed solely by the law of the contract governing such agreements. Although some interpretation issues arise, this provision serves to support and consolidate the protection of close-out netting provisions in accordance with their terms and shields netting contracts from the insolvency law provisions of the home Member State.

The analysis of EU netting law has focused on the provisions of the Financial Collateral Directive and the BRRD as these are directly relevant to the research question. The enforceability of close-out netting provisions under the Financial Collateral Directive is based on the principle of party autonomy and recognises the enforceability of close-out netting provisions according to their terms notwithstanding the commencement of insolvency proceedings. This protection is based on the need to safeguard financial stability and limit systemic risk. Limitations are set on the unrestricted applicability of party autonomy by Recital (15) which provides that the Directive is to apply without prejudice to any restrictions or requirements under national law on netting, giving as examples the reciprocity of the obligations or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement of insolvency proceedings.

In the aftermath of the financial crisis the EU legislator re-considered its approach on the effects on systemic risk caused by the exercise of contractual termination rights. This is reflected in the adoption of the BRRD which

76 Mevorach criticises the FSB Key Principles as being too insufficiently precise and incomplete 'to create a strong enough obligation to adhere to a uniform regime'. See MEVORACH (2018) 247. This criticism may be levied at most of the declarations made by the international regulatory bodies cited in this chapter (maybe with the exception of the EU sources) so that there remains a wide margin of discretion in the way in which national legislators implement them.

has amended the provisions on netting found in the other three Directives with the intention of protecting the effectiveness of resolution measures in the interests of financial stability. This Directive is limited in personal scope since it applies only to credit institutions and investment firms. It provides that the taking of resolution measures shall not be deemed to constitute an enforcement event under the Financial Collateral Directive or insolvency proceedings under the Settlement Finality Directive. It also provides that the private international law rule applying under the Banks Winding-Up Directive which refers to the law governing the netting agreement shall apply without prejudice to the resolution authority's exercise of powers under the BRRD. These relate to the fact that the taking of any crisis prevention measure or crisis management measure is not deemed to be an enforcement event leading to early termination of contracts and the selected law should apply without prejudice to the powers of the resolution authority to impose a temporary stay on the exercise of termination rights in relation to private contracts.

The scope of Part I has been to provide an introduction to the concept of close-out netting, with particular focus on its relationship with set-off, on the interaction of close-out netting with national insolvency and resolution laws and on the sources of the *lex mercatoria* which were instrumental to both develop close-out netting as a market tool and to influence national legislators to give statutory recognition to this concept. These features will be analysed again in Part II from the point of view of the laws of the three selected jurisdictions and will form the basis for the replies to the three sub-questions raised in the Introduction under the laws of these jurisdictions.