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

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Part II

National Close-out Netting Regimes

4 Insolvency Close-out Netting under English Law

4.1 Overview of the Regulation of Insolvency Close-out Netting under English Law

This is the first of three chapters dealing with the application of insolvency close-out netting under national law, the first being under English law which hails from a common law jurisdiction and is traditionally considered to give favourable treatment to pre-insolvency contractual entitlements such as insolvency close-out netting.[1] The aim of each of these national law chapters is to provide preliminary (and partial) replies to the three sub-questions raised in the Introduction to this research, i.e. on the influence of set-off rules, insolvency law and resolution regimes on the recognition granted by the legislator to insolvency close-out netting provisions, whilst more conclusive replies will be provided in Part III.

In order to arrive at these considerations, each national law chapter will be similarly structured first to provide a brief overview of the national insolvency proceedings, bank resolution law and the applicable laws which regulate insolvency close-out netting. This is followed in the second part by a comparative analysis of the constitutive elements of the concepts of close-out netting and insolvency set-off as regulated by national law, in the third part by an examination of the way in which close-out netting developed under national law and how it was affected by the promulgation of bank resolution regimes, and in the fourth part by considering the rationale and principles forming the basis of national insolvency law in order to gain insight into whether the regulation of insolvency close-out netting can be understood in the light of any public policy or insolvency goal established by the state.[2]

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1 For an explanation of the English pre-insolvency entitlements regime, see PECK *et al.* (2011) 4.

2 The consideration of national laws is, naturally, based on the same premises of the research question, namely that it is limited to the operation of bilateral insolvency close-out netting considered from a substantive law point of view in the field of the OTC derivatives, repo and securities lending markets in relation to corporate entities, excluding clearing houses and central counterparties as well as payments and securities settlement systems, except where references to these serve to strengthen or illustrate a legal argument that is being made.

Insolvency Rules

The insolvency rules of a jurisdiction form the backdrop against which a close-out netting provision operates when it is triggered by the occurrence of an insolvency event. It is therefore deemed relevant to commence with a brief overview of the main insolvency rules which are affected by the exercise of a close-out netting provision. It is not intended to delve into a detailed explanation of these rules, but it will suffice to give an idea of how English insolvency proceedings operate in order to give a context to the arguments made in this chapter.[3] This part deals only with the domestic procedural aspects of English insolvency law and does not consider cross-border insolvencies.

Under English law, insolvency proceedings are predominantly regulated by the Insolvency Act 1986, as further elaborated by the Insolvency (England and Wales) Rules 2016.[4] There are four main types of insolvency proceedings under English law, namely liquidation or winding-up,[5] administration,[6] receivership[7] and voluntary arrangement[8] of which the first two are more relevant for the purposes of this research. Liquidation leads to the dissolution of a company and consists in preserving the company's assets, the determination of its liabilities and the distribution of its assets among its creditors. Liquidation can commence following a compulsory winding-up order by a court upon a petition by a creditor or a voluntary winding-up either by the company's shareholders (in the case the company is still solvent) or by its creditors. In both types of liquidation, a liquidator is appointed to take control of the company's affairs[9] for the purpose of its beneficial winding up and eventual distribution of its assets

3 For a more detailed explanation of English insolvency law proceedings, see McKNIGHT (1996, updatable), para 38 *et seq.* For an explanation of the historical development of English insolvency law, see FLETCHER (2017) 1-015; VAN ZWIETEN (2018) 9.

4 S.I. 2016/1024. These Rules replaced the former Insolvency Rules 1986 (S.I. 1986/1925) with effect from 6 April 2017.

5 See section 73 *et seq.* of the Insolvency Act 1986.

6 See section 8 *et seq.* of the Insolvency Act 1986.

7 See section 28 *et seq.* of the Insolvency Act 1986. Administrative receivership is one of three forms of receivership whereby an administrative receiver is appointed by a security holder with a floating charge over the whole or substantially the whole of the company's assets to hold and realise the security for the benefit of the secured creditor. This form of procedure is no longer in common use since section 250 of the Enterprise Act 2002 prevented, with some exceptions, the appointment of administrative receivers with respect to security taken on or after 15 September 2003.

8 See section 1 *et seq.* of the Insolvency Act 1986. A voluntary arrangement is essentially a form of compromise amongst a company's creditors whereby creditors of the company representing seventy-five per cent of the value of the debts of the company can bring about a moratorium on other creditor action whilst the arrangement is in place.

9 See section 91 of the Insolvency Act 1986.

to creditors.[10] His duties are owed to the company and to the general body of creditors. Administration is essentially a rehabilitation procedure introduced by section 248 of the Enterprise Act 2002 to promote the preservation of business[11] and is usually commenced by the company. The promulgation of the administration procedure gave rise to what become known in English insolvency law as the 'rescue culture', giving preference to reorganising companies so as to restore them to profitable trading and enable them to avoid liquidation. An administrator may be appointed through a court or out-of-court procedure.[12] In both instances, the administrator is given statutory powers to rehabilitate the company. When it is not possible to restore the business to profitable trading, the administrator may apply to the court to wind up the affairs of the company thereby 'achieving a better result for the company's creditors as a whole than would be likely in the company were wound up' under liquidation proceedings.[13] A particular form of administration that has gained popularity is the pre-packaged administration, or 'pre-pack' as it is known, in which a company in financial difficulty, with the approval of its dominant creditors and the involvement of an insolvency practitioner as prospective administrator, reaches an agreement for the sale of its business or all of its assets shortly before going into administration. The agreement is placed in escrow (*i.e.* in custody or trust) pending the appointment of the administrator and the sale takes effect immediately on such appointment.

Certain principles of English insolvency law are directly impacted by the enforceability of close-out netting provisions. One important principle is the so-called 'stay'.[14] On the making of a winding up order in liquidation and on the commencement of administration, individual legal actions against the debtor are stayed, except with the leave of the court, and attachments and other forms of execution proceedings that have not been completed are avoided in order to transfer control of the company's assets

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10 English insolvency law establishes a ranking of payment in a liquidation as follows: (i) ownership of assets, fixed security over assets and insolvency set-off; (ii) liquidation expenses; (iii) preferential creditors, *i.e.* claims for occupational pension scheme contributions, unpaid employees' remuneration and coal and steel contributions; (iv) secured creditors with a floating charge; (iv) unsecured creditors (other than preferential creditors); and (v) company members. See, in particular, sections 175 and 328 of the Insolvency Act 1986.

11 This is the primary objective of administration. For other, subsidiary, objectives see para 3, Schedule B1 of the Insolvency Act 1986.

12 This out-of-court procedure is available to certain secured creditors or the company or its directors by filing a notice of appointment and other prescribed documents. See paras 14, 18(1) 22 and 29(1), Schedule B1 of the Insolvency Act 1986.

13 Para 3(b), Schedule B1 of the Insolvency Act 1986.

14 See, for instance, sections 126 & 130(2) and paras 42 & 43, Schedule B1 of the Insolvency Act 1986.

and affairs to the liquidator or administrator. A second important principle relates to the measure that may be taken by the liquidator relates to the right to 'disclaim onerous property'.[15] Under section 178(4), the disclaimer operates to determine the rights, interests and liabilities of the insolvent company under the disclaimed contract, although this does not affect the rights or liabilities of third parties. Any loss or damage sustained by the other party to the contract in consequence of the disclaimer is, under section 178(6) provable[16] in the liquidation. The right of the liquidator to disclaim raises the issue of 'cherry-picking' whereby the liquidator is entitled to decide which particular contracts or rights to assets to disclaim, thereby bringing them to an end, and which he wishes to enforce. The solvent party may therefore find itself in a position of having to continue to perform under the contracts which are profitable for the insolvent company whilst having to prove in the insolvency for the loss it has suffered in consequence of the termination of the disclaimed contracts. Third, an important principle of English insolvency law is that unsecured creditors rank *pari passu* (*i.e.* rateably) in their entitlement to the distribution of the insolvent debtor's assets in a winding-up and where there is to be a distribution in an administration.[17] A procedural measure giving effect to this principle is that arrangements between a debtor and certain of its ordinary creditors will be struck down if they have the effect, even unintentionally, of putting the claims of those creditors ahead of the debtor's other unsecured creditors without their consent in the insolvent winding-up of the debtor.

The Banking Act 2009 provides specialist legislation dealing with the insolvency of deposit-takers, namely credit institutions[18] and building societies. It follows the adoption of the Banking (Special Provisions) Act 2008, which was a temporary piece of legislation allowing the UK authorities to take action to deal with the failure of Northern Rock plc as well as later instances of bank failures.[19] The Banking Act 2009 was extended to cover investment banks in 2011 by virtue of the Investment Bank Special Admin-

15 See section 178 of the Insolvency Act 1986. Onerous property is defined in section 187(3) to include any unprofitable contract, and any other property of the company which cannot be sold or which may give rise to a liability to pay money or perform any other onerous act.

16 This term refers to the procedure for proof of debt, set out in rule 4.73 of the Insolvency Rules 1986, whereby a creditor of an insolvent debtor, wishing to be considered for the purposes of voting and payment of the so-called 'dividend' from the proceeds of the liquidation of the insolvent estate, is required to submit a formal claim to the liquidator.

17 See sections 107 and 328(3) of the Insolvency Act 1986 and rule 14.12 of the Insolvency Rules 2016.

18 See, in this respect, the definition of 'bank' in section 2 of the Banking Act 2009 and the definitions of 'banking institution' in article 2 of each of the Banking Act 2009 (Restriction of Partial Transfers Order) 2009 (S.I. 2009/322) and the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 (S.I. 2014/3350).

19 See Louise Verrill & Paul Durban, 'United Kingdom (England and Wales)', in HAENTJENS & WESSELS (2015) 526.

istration Regulations 2011.[20] The Banking Act sets out three types of procedures to deal with failed or failing banks, namely resolution, insolvency[21] and administration,[22] so that these are no longer subject to the insolvency proceedings of the Insolvency Act 1986 if they hold insured deposits. The resolution regime consists of stabilisation options which are essentially powers conferred on designated authorities, namely the Bank of England, the Treasury, the Financial Conduct Authority and the Prudential Regulatory Authority, involving transfers of the assets and liabilities of banks to either (i) a private sector purchaser, (ii) a 'bridge bank' or (iii) temporary public ownership, and also the bail-in option providing for the transfer of securities issued by a specified bank to be transferred to a resolution administrator or another person.[23] Under the bail-in option, securities may also be cancelled, reduced or converted into equity instruments. Gleeson & Guynn explain that bank resolution is an alternative to insolvency and may be applied only if some form of public interest test in their use is met. According to these authors, the idea is to make insolvency the norm and resolution the exception.[24] The Code of Practice which accompanies the Banking Act 2009 notes that:

> '[t]he Bank of England may only exercise a stabilisation power if satisfied that the exercise of the power is necessary having regard to the public interest in the advancement of one or more of the special resolution objectives, and that one or more of the special resolution objectives would not be met to the same extent by the winding up of the bank – including through the use of the bank insolvency procedure […] The test of "necessity" is a high one.'[25]

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20 S.I. 2011/245.

21 See Part 2 of the Banking Act 2009. The insolvency procedure leads to the liquidation of the bank. In terms of section 95, there are three grounds for the application of a bank insolvency order, namely that a bank is unable, or likely to become unable to pay its debts; that the winding up of the bank would be in the public interest and that the winding up of the bank would be fair. The bank insolvency procedure may be resorted to by the authorities if they do not consider it appropriate to seek to resolve the failing bank through use of one of the stabilisation options. See Louise Verrill & Paul Durban, 'United Kingdom (England and Wales), in HAENTJENS & WESSELS (2015) 530.

22 See Part 3 of the Banking Act 2009. The procedures for bank administration are of a consequential nature since they deal with the part of a bank's business that remains with the so-called 'residual bank' when a stabilisation power is used to transfer only some of its assets to a commercial purchaser or a 'bridge bank'.

23 The authorities may use the stabilisation options or resort to the bank insolvency procedure, only when the Prudential Regulation Authority is satisfied that: (a) the bank is failing, or is likely to fail, to satisfy the threshold conditions set out by the Financial Conduct Authority to permit it to carry on regulated activities; and (b) subject to consultation with the Financial Conduct Authority, the Bank of England and the Treasury, it is not reasonably likely that other actions will be taken to enable it to satisfy those threshold conditions. See sections 7 and 96 of the Banking Act 2009. For an effectiveness assessment of the English resolution regime, see CAMPBELL & MOFFATT (2015) 66.

24 GLEESON & GUYNN (2016) 230.

25 HM TREASURY 2017 SRR Code of Conduct, paras 6.24 and 6.25.

Among these objectives, section 4 of the Banking Act 2009 lists the public interest in the stability of the financial system of the UK, the maintenance of public confidence in the stability of that system and the protection of depositors.

The Financial Collateral Arrangements (No. 2) Regulations 2003

The Financial Collateral Arrangements (No. 2) Regulations 2003 (FCAR) is the main substantive English legal act regulating close-out netting in the OTC market. The provisions regulating insolvency close-out netting under the FCAR are regulations 10(1)(b) and 12 to 14, intended to implement Articles 7(1) and 8 of the EU Financial Collateral Directive. It may be noted that the FCAR does not implement Article 7(2) of the EU Directive obliging Member States to ensure that the operation of a close-out netting provision is not subject to formal requirements listed in Article 4(4) of the same Directive, since it is stated in a consultation document issued by HM Treasury on the implementation of the EU Financial Collateral Directive (the FCAR consultation document) that there are no such requirements under English law which affect the operation of close-out netting provisions 'so it is not necessary for the draft regulations to contain any specific provision implementing that part of the Directive.'[26]

In relation to the scope of application of the FCAR close-out netting provisions, regulation 3 of the FCAR provides that a close-out netting provision is a term in a financial collateral arrangement or an arrangement of which a financial collateral arrangement forms part or in any legislative provision.[27] The financial collateral arrangement can be either a title transfer or a security type of financial collateral arrangement. The collateral should consist of cash, financial instruments or credit claims. Whilst the material scope of the FCAR is relatively similar to that of the EU Financial Collateral Directive, the personal scope is significantly wider. The application of the EU Directive is limited to specified financial market participants or corporate entities dealing with a specified financial market participant. Under the FCAR the collateral-provider and the collateral-taker are both defined as 'non-natural persons'.[28] A non-natural person is, in turn, defined to mean any corporate body, unincorporated firm, partnership or body with legal personality except an individual. In terms of the FCAR consultation documentation, the FCAR is made to apply to corporate bodies generally since this was considered consistent with the overall policy objectives and position in UK law, and furthermore it simplifies implementation by avoiding the need for reintroducing elaborate definitions similar to those

26 HM TREASURY 2003 FCAR Consultation Document, para 4.6.

27 For a critique of the definitions used in the FCAR which affect the scope of these same Regulations, see HUGHES (2006) 65.

28 See regulation 3 of the FCAR.

of Article 1(2)(c) of the EU Directive.[29] The question arises why the scope of this regulation was not extended to cover also physical persons, given the general enforceability of close-out netting provisions as highlighted in the FCAR consultation document? The reason provided seems to be a technical one, in the sense that the FCAR was enacted on the basis of the implementing powers of section 2(2) of the European Communities Act 1972[30] and it appeared to the English legislator to be legally unfeasible to extend this legal basis to cover individual business relationships. However, the document declares that English law already recognises the enforceability of close-out netting provisions in these types of business relationships involving individuals or sole traders.[31]

Regulation 12 bases the applicability of insolvency close-out netting on the basis of contractual freedom by providing that a close-out netting provision shall take effect 'in accordance with its terms' notwithstanding that the collateral-provider or collateral-taker under the arrangement is subject to winding-up proceedings or reorganisation measures. The term 'winding-up proceedings' is defined in regulation 3 to include winding up by the court or voluntary winding up in terms of the Insolvency Act as well as bank insolvency under the Banking Act 2009, whilst 'reorganisation measures' include administration, a company voluntary arrangement and the making of an interim order on an administration application in terms of the Insolvency Act. It is interesting to note that reorganisation measures

29 HM TREASURY 2003 FCAR Consultation Document, paras 2.2 and 2.3. In *R (on the application of Cukurova Finance International Ltd) v HM Treasury* [2008] EWHC2567 (Admin) at [96] the applicant challenged the validity of the FCAR on the grounds that the personal scope goes beyond the scope of Article 1(2)(a)-(d) of the FCD which is limited to the wholesale market as this represented a significant inroad into the rights of unsecured creditors in an insolvency. The judge considered that the time for presenting the application had expired and he did not consider it necessary to extend time so that there is no final judgment on this issue. The judge, however, stated *obiter* that the FCAR struck a different balance than did the FCD but he did not consider that the widening of the scope of protection undermined the objectives of the FCD. Reservations to this *obiter dictum* were made by the UK Supreme court in *The United States of America v Nolan* case ([2015] UKSC 63) where the court noted that the extension of the scope of the FCD was not a matter for the executive (*i.e.* the Treasury which issued the FCAR) to decide, but for Parliament to agree as a matter of primary legislation. The Financial Market Law Committee in a paper of July 2008 entitled 'Issue 132 – Alfa Telecom Turkey Ltd v Cukurova Finance International Ltd and Cukurova Holdings AS: Legal Assessment of an issue raised in the above case, namely the extent to which the Financial Collateral Arrangements (No 2) Regulations 2003 are ultra vires the European Communities Act 1972' concluded that the FCAR were *intra vires* section 2(2)(b) of that Act.

30 Given the cut-off date of 31 December 2019 set for updating this research, the effects of the exit of the United Kingdom from the EU (Brexit) will not be dealt with in this chapter. However, it is important to note that following Brexit, the European Union (Withdrawal) Act of 2018 will repeal the European Communities Act 1972 and will copy into domestic law all directly applicable EU law which will be in operation on exit day. For a general commentary of the impact of a no-deal Brexit on the financial markets, see PERKINS & PAREKH (2019) 652; DOWNE (2019) 658.

31 HM TREASURY 2003 FCAR Consultation Document, para 2.4.

do not also include resolution measures under the Banking Act 2009. The reason for this, as will be examined in more detail below, is that the Banking Act itself regulates the substantive aspects of insolvency close-out netting in relation to its provisions in a manner which is different from that currently obtaining under the FCAR. This is intended to safeguard the effectiveness of bank resolution measures.

The rule in regulation 12 that a close-out netting provision should take effect in accordance with its terms is subject to the condition in its sub-regulation (2) that at the time the financial collateral arrangement was entered into the solvent party did not have knowledge or the constructive knowledge that winding-up proceedings or reorganisation measures had commenced.[32] The solvent party is deemed to possess actual knowledge if it had notice that a meeting of creditors of the other party had been summoned or that a petition for the winding-up of the other party or an application for an administration order was pending or that any person had given notice of an intention to appoint an administrator and liquidation of the other party to the financial collateral arrangement was immediately preceded by an administration of that party.[33] Sub-regulation (4) then provides that certain provisions of the Insolvency Rules 1986, now replaced by the Insolvency Rules 2016, on set-off in administration or on winding-up shall not apply to close-out netting provisions under regulation 12 unless in terms of regulation 12(2)(a) there was knowledge (constructive or actual) of the winding-up proceedings or the reorganisation. In terms of regulation 13, if the relevant financial collateral arrangement came into existence on the day of but after the moment of commencement of the winding-up proceedings or reorganisation measures, the close-out netting provision is legally enforceable if the collateral-taker can show that he was not aware, nor should have been aware, of the commencement of such proceedings or measures. Regulation 14 provides that conversion of foreign currency amounts shall take effect in accordance with the provisions of the close-out netting provision rather than the relevant insolvency set-off rules, namely rule 14.21 of the Insolvency Rules 2016.

Fawcett considers the proposition whether the FCAR covers transactions entered into after insolvency when these are governed by a master agreement entered into prior to the insolvency. He considers that such a transaction may be deemed to be a future obligation at the time when the master agreement was executed and would fall under the definition of 'relevant financial obligations' of the FCAR and thus be covered by regula-

32 Regulation 12(3) provides that winding-up proceedings commence on the making of a winding-up order by the court and reorganisation measures commence on the appointment of an administrator, whether by a court or otherwise. This provision varies the general rule in relation to the opening of winding-up proceedings under section 129 of the Insolvency Act 1986 in terms of which these proceedings commence on the filing of a petition order.

33 Regulation 12(2) of the FCAR.

tion 12(1) of the FCAR. However, if the solvent party had notice, or should have notice, of the insolvency of its counterparty then it is expected that the transaction would be excluded from regulation 12(1) on account of regulation 12(2) of the FCAR.[34]

Finally, in order to enforce the recognition of close-out netting provisions, regulation 10(1)(b) specifically provides that Section 127 of the Insolvency Act on avoidance of property dispositions shall not apply to prevent a close-out netting provision taking effect in accordance with its terms.[35] Section 127 provides that any disposition of the company's property or transfer of shares which is made after the commencement of winding-up is void, unless the court orders otherwise. Hence, this provision makes any disposal invalid on the sole basis that it is made in a prescribed period prior to the court's order to wind up the company.[36]

4.2 Constitutive Elements of Insolvency Close-out Netting

One common approach typically adopted as a means to examine the constitutive elements of a legal concept is to analyse any applicable statutory definitions.[37] The best starting point to discern the constitutive elements of close-out netting under English law is arguably the close-out netting definition and provisions of the FCAR. The FCAR define a 'close-out netting provision' in regulation 3(1). In terms of this definition, the following elements are encompassed in the concept of close-out netting:

(a) it arises from a contractual or statutory provision,
(b) if contractual, it is related, at least in part, to a financial collateral arrangement,
(c) the provision is triggered by an enforcement event,
(d) there are two types of extinguishment of obligations, namely by acceleration of maturities or by termination,
(e) the calculation of the value of the obligation is based either on the original obligation's estimated current value or its replacement cost,
(f) setting off or netting the amounts due under the valued obligations by each party, followed by payment of the net balance.

34 FAWCETT (2005) 296.

35 Regulation 10(1)(b) of the FCAR.

36 According to the FCAR consultation document, this safeguard was required to implement Article 8(1)(b) of the EU Directive since section 127 of the Insolvency Act applies *ipso facto.* See HM TREASURY 2003 FCAR Consultation Document, para 5.12.

37 Although the regulation of netting in payment systems is outside the scope of this research, it may be remarked that the first statutory definition of netting was provided in regulation 2(1) of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999, S.I. 1999/2979, intended to implement the provisions of the EU Settlement Finality Directive. The definition of netting under these Regulations relates to settlement netting and serves the functionalities of the settlement of payments in a payment system.

These elements are also comprised in the definition of the same term found in Article 2(1)(n) of the EU Financial Collateral Directive, except for the reference to 'replacement cost' which has been added in regulation 3(1) of the FCAR in order to provide for the market valuation mechanism of certain derivatives transactions following a close-out under certain master agreements such as the ISDA Master Agreement.[38] According to Yeowart *et al.*, this definition of close-out netting envisages two ways in which close-out netting can take place, namely 'by accelerating the obligations, valuing them and setting off the obligations of each party to the other' to achieve a close-out amount, termed the 'set-off approach', or 'by terminating the obligations and replacing them with new obligations with the close-out amount being determined by reference to the market valuation of the terminated transactions', termed the 'conditional novation approach'.[39]

As a preliminary remark, it may be said that the definition of close-out netting under the FCAR is a functional definition which includes the procedural steps of the close-out process which a market practitioner is accustomed to follow in a financial collateral arrangement.[40] In order to fall within the scope of the FCAR, the close-out netting clause has to be a term of a financial collateral arrangement or of an arrangement of which a financial collateral arrangement forms part. *Prima facie,* the provisions of the FCAR therefore only apply to close-out netting provisions governed by collateralised debt obligations, not to unsecured obligations, and they are limited to those associated with financial collateral arrangements. The definition, however, also refers to a close-out netting provision being a legislative close-out netting provision. Yeowart *et al.* note that the FCD also refers to 'any statutory rule' in its Article 2(1)(n) definition. However, whilst under the FCD a statutory rule can be a close-out netting provision only 'in the absence of' a contractual provision dealing with close-out netting, under the FCAR the statutory rule may exist in parallel with the contractual provision in particular when taking into account the mandatory provisions of insolvency set-off.[41]

Doubts were expressed in Chapter 3.3.1.1 whether the FCD definition of a close-out netting provision covers cross-product netting. Ho notes that it is possible that a bilateral cross-product netting agreement may fall within the

38 See *Response of the United Kingdom to the Commission Questionnaire to Member States for the drafting of the Evaluation Report* (January 2006) at para 2.1(n). See also Section 6(e)(1) of the 2002 ISDA Master Agreement on the calculation of a close-out amount, analysed in Chapter 1.3.1.

39 YEOWART *et al.* (2016) 223 & 446.

40 It will be seen in part 2.1 below that the FCAR definition does not encompass the full range of close-out netting possibilities under English law, which also recognises close-out netting provisions outside of a financial collateral arrangement under equity and common law. See EUROPEAN COMMISSION 2006 FCD Evaluation Report, at para 4.4.

41 YEOWART *et al.* (2016) 224. The relationship between the close-out netting and insolvency set-off regimes is analysed in part 2.1 of this chapter.

definition of a close-out netting provision of the FCAR whereby an event of default under one master agreement will trigger an event of default under another or more master agreements concluded between the same parties, each of which may be defined as a financial collateral arrangement in terms of the FCAR, and the close-out amounts due under each master agreement will be netted out to produce a single net amount.[42]

The structural definition of a close-out netting provision found in the FCAR is in sharp contrast with the more generic definition of 'netting arrangements' found in section 48(1)(d) of the Banking Act 2009 and repeated in section 48P. In terms of this latter definition, netting arrangements are said to consist of 'arrangements under which a number of claims or obligations can be converted into a net claim or obligation' and which includes 'in particular, "close-out" netting arrangements under which actual or theoretical debts[43] are calculated during the course of a contract for the purpose of enabling them to be set off against each other or to be converted into a net debt'. The definition in the Banking Act is worded in generic terms as it is meant to cover various netting arrangements whether arising under the FCAR or under other sources and is therefore not restricted to a financial collateral arrangement.

This is admittedly not a very precise definition of the concept of close-out netting since its purpose is not the specific regulation of close-out netting. It does refer to some elements of close-out netting, such as the calculation of debts during the course of a contract and the determination of a net amount. However, it does not refer to any method of calculation nor to the fact that termination or acceleration should be affected. This definition only provides minimalistic features of close-out netting to ensure that the definition is not limited in any way since the legislator probably intended to capture the widest range of close-out netting arrangements. In fact, it may be interesting to note that whilst the Banking Act definition does not refer to the occurrence of a termination event which triggers the closing out of the netting arrangement, it refers instead to the conversion into a net debt of actual or theoretical debts calculated 'in the course of a contract'. This latter wording implies that the contract is still effective and has not been terminated, which thus enables the resolution authority to take the necessary measures of either bailing in the contractual obligations or transferring

42 HO (2012) 353. Ho, however, does not think that the definition is wide enough to cover multi-party netting, where the claims and crossclaims are not mutual since the definition and the provisions of the FCAR regulate the bilateral relations of the collateral-taker and collateral-provider. The element of mutuality will be analysed later in this chapter. *Ibid.* 354.

43 The reference to 'theoretical debts' is possibly to derivatives based on nominal values which involves the setting off of the values of those debts against each other or their conversion into a net debt.

them to another entity.[44] This is reminiscent of the liquidator's powers under the Insolvency Act 1986 to deal with contracts, other than financial contracts, in the best interests of the insolvent estate. It may also be noted that since the Banking Act predates the EU's BRRD, it does not reproduce the definition of close-out netting found in the latter. Nor does it refer to or link up with the definition of close-out netting provision in the FCAR though, as already seen above, it does affect the close-out netting provisions of the FCAR. This is further indicative of the intention of the legislator to include a wider range of close-out netting provisions beyond the scope of the FCAR.

It may be observed that under both the FCAR and, to a lesser extent, the Banking Act close-out netting is defined in terms of the steps or phases involved in executing a close-out netting provision, reflecting the close-out conventions of the particular markets in which it operates. It is also clear that set-off is considered by English law to be intertwined with the process of close-out netting since in the final stage both definitions refer to the set-off process for the purposes of determining a single net amount. Yeowart *et al.* confirm that the reference to set-off in the third stage of close-out netting is to contractual set-off and not insolvency set-off. Nonetheless, this implies that for close-out netting, as with set-off, the obligations should be mutually owed for the setting off of obligations to be possible under a close-out netting provision.[45]

In a rather sweeping statement Benjamin states that the key elements in the FCAR definition of close-out netting are:

> 'default; the acceleration of the time for performance of obligations to the time of default; the conversion of non-cash obligations into debts (for example, an obligation to deliver a non-cash asset is converted into the obligation to pay its market price at the time of default); and set off.'

Benjamin states that where the event of default is the insolvency of a UK company, the set-off will arguably take place in accordance with the mandatory provisions of the UK Insolvency Rules and 'the contractual provisions are drafted to track the effect of these'.[46] This statement is rather surprising since it implies that under English law a close-out netting provision will be primarily governed by mandatory set-off law, where applicable, rather than by the party autonomy principle applying under regulation 12 of the FCAR.

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44 It will be seen later in this chapter that whilst the BRRD envisages the termination of close-out netting provisions so that only net amounts are subject to the bail-in provision, under the Banking Act the bail-in provision operates on net amounts but does not impose the termination of contracts.

45 YEOWART *et al.* (2016) 448. This is confirmed in the English Law Opinion on the ISDA Master Agreements delivered by Allen & Overy LLP. See ISDA 2019 Allen & Overy 19.

46 BENJAMIN (2007) 268.

It also contradicts the number of disapplied or modified provisions made to the insolvency set-off rules in regulations 12 and 14 of the FCAR to ensure that the enforceability of close-out netting is not restricted by the insolvency set-off rules and it does not take into account the argument made earlier that the reference to set-off in the third phase of close-out netting is a reference to contractual set-off, not insolvency set-off.

The number of references made in the FCAR to the insolvency set-off rules indicates a close relationship with insolvency close-out netting. The concern about the application, or disapplication, of a number of insolvency set-off rules also stems from the fact that the latter are mandatory and self-executing. The close affinity between insolvency set-off and close-out netting is due mainly to the fact that prior to the FCAR the rules of insolvency set-off were resorted to in order to give legitimacy to the enforcement of close-out netting provisions. However, this created uncertainties of legal soundness for those close-out netting provisions which were not based on insolvency set-off rules and this may be the reason why authors like Benjamin caution on the influence of insolvency set-off rules on the operation of close-out netting provisions, at least if they do not fall under the scope of the FCAR.[47]

The situation regarding the recognition of close-out netting prior to the FCAR may be surmised from a Guidance Notice entitled 'Netting of Counterparty Exposure' issued by the Financial Law Panel[48] in 1993 to explain that the legal foundation in England for netting and set-off was considered robust. In terms of the Statement of Law made by the Panel:

> 'Where a company goes into insolvent liquidation in England and there have been mutual credits, mutual debts or other mutual dealings between the company and another party prior to liquidation, set off applies. An account must be taken of the mutual dealings and the ultimate net balance only is required to be paid to the liquidator or proved for in the liquidation.
> […]

47 This is confirmed by Yeowart *et al.* who state that prior to the FCAR, it was common practice to draft close-out netting provisions in a way which matches the results achieved by insolvency set-off. See YEOWART *et al.* (2016) 228.

48 The Financial Law Panel was set up in 1992 under the auspices of the Bank of England to work with the market to reach practical solutions to legal uncertainties as they affect wholesale markets and services in the UK. The statements and reports of the Financial Law Panel are now available on the website of the Financial Markets Law Committee at <http://www.fmlc.org>.

> Where a bank and its corporate customer enter into various transactions with each other prior to the customer's insolvent liquidation and the customer goes into liquidation before the transactions are closed mandatory set off applies. The bank will have a claim (or obligation) on a net basis only to receive from (or pay to) the liquidator the net amount in respect of the transactions taken as a whole.'[49]

This statement seems to suggest that if a close-out netting provision regards mutual obligations arising prior to the liquidation and the other party becomes insolvent before the transactions are closed, then mandatory set-off will apply and only the net amount is payable. It is not clear if the Financial Law Panel is referring to all three phases of close-out netting, *i.e.* termination, calculation and determination of a single net amount, which are regulated by mandatory set-off rules or only the third phase of determining a single net amount. It is also not clear whether the contractual enhancement features of close-out netting which go beyond the provisions of insolvency set-off rules are also protected or whether these contractual enhancements could, prior to the enactment of the FCAR, be held invalid by the courts as a means of contracting out of the insolvency rules.[50]

A better understanding of the implications of this statement and of the impact brought about by the FCAR on the recognition of close-out netting provisions may be obtained by undertaking a comparative analysis of the concepts of insolvency set-off and insolvency close-out netting and their

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49 FINANCIAL LAW PANEL 1993 Netting Guidance Notice, Schedule 1 – Statement of Law. The Statement lists a number of assumptions amongst which is that the transactions referred to consist of contracts for forward and spot foreign exchange, cross-currency and interest rate swaps, currency and interest rate options (including caps, floors and collars), forward rate agreements and similar commodity and equity-related derivatives, as well as loans by and deposits with a bank. According to McCormick, this statement was issued by the Financial Law Panel to address uncertainty in the market following some court judgments at the time about the enforceability of set-off and netting provisions especially upon the insolvency of one of the parties. See McCORMICK (2010) 234. This position is confirmed in the FCAR consultation document which states that:

> '[a]lthough there are no provisions of the Insolvency Act which we consider it necessary to disapply from financial collateral arrangements in order to give effect to Article 7(1) [of the EU Financial Collateral Directive], draft regulation 13 includes an express provision that close-out netting provisions are to take effect in accordance with their terms'. The reason given for this is 'to deal with any doubts there may be about the effectiveness of such terms when a company becomes insolvent due to common law or equitable principles […].'

HM TREASURY 2003 FCAR Consultation Document, para 5.9.

50 See GULLIFER (2017) 386. See, for instance, *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 2 All E.R. 390 regarding an arrangement between airlines for the multilateral settlement of payments on a net basis. The court held that the contractual provision for multilateral set-off was ineffective in the insolvency of a party since it was deemed as contracting out of the provisions of section 302 of the Companies Act 1948 for the payment of unsecured debt *pari passu*.

applicable regulation. This will be achieved in the succeeding part by first analysing the concept of insolvency set-off under English law and then comparing its features with those of the close-out netting technique in order to determine and assess the contractual enhancements of the latter. The discussion whether close-out netting is to be considered as a stand-alone concept will be conducted in Part III. The analysis of insolvency set-off in this chapter will focus on aspects which are considered more relevant to the research question.

4.2.1 Insolvency Set-off under English Law

The principal rule on insolvency set-off is found in rule 14.25 of the Insolvency Rules 2016[51] which in essence provides that where, before a company goes into liquidation:

> 'there have been mutual dealings between the company and a creditor of the company … an account shall be taken of what is due from the company and the creditor to each other in respect of the mutual dealings and the sums due from one must be set off against the sums due from the other.'

The right of set-off may therefore be exercised where an insolvent debtor and a creditor have had pre-insolvency mutual dealings giving rise to cross-demands. Without this right the creditor would be obliged to pay the full amount of his debt to the liquidator and would be constrained to proving with other creditors for the amount owed to it by the insolvent party. But if the requirements of rule 14.25 are fulfilled, only the balance remaining after deducting one claim from the other is payable. Insolvency set-off applies in relation to any type of obligation whether arising by virtue of an agreement or the law or otherwise. It applies to individuals and companies in relation to both liquidation and administration once the administrator has issued a notice of a proposed distribution.[52] For the purposes of this research, the focus will be on rule 14.25 of the Insolvency Rules 2016 since any substantive aspects of the insolvency set-off right under rule 14.25 also apply under other insolvency set-off provisions.

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51 For the different types of set-off under English law, see GULLIFER (2017) 305; WOOD (2007) 5; DERHAM (2010) 247; YEOWART *et al.* (2016) 601.

52 Thus, similar set-off rules apply under section 323 of the Insolvency Act 1986 in relation to bankruptcy proceedings of individuals, rule 14.24 of the Insolvency Rules 2016 in relation to administration proceedings, rule 72 of the Bank Insolvency (England and Wales) Rules 2009 (S.I. 2009/356) and rules 58 to 60 of the Bank Administration (England and Wales) Rules 2009 (S.I. 2009/357) , but with some changes to reflect the different procedures.

Conceptual Issues

Insolvency set-off is primarily considered a substantive right, rather than procedural, since it affects the substantive rights of the parties by enabling the solvent creditor to use its indebtedness to the insolvent party as a form of security.[53] Any type of debt may be subject to insolvency set-off provided it is provable in the insolvency proceedings.[54] Debts owing to the insolvent party should be legally enforceable to enable the insolvency practitioner to claim it. Set-off is not confined to consensual dealings but covers also the imposition of a statutory obligation analogous to a guarantee and even the commission of a tort related to a business dealing.[55] There are, however, doubts whether secured debt is subject to mandatory set-off as will be explained below.

The basic principles regulating insolvency set-off based on an interpretation of the former rule 4.90 of the Insolvency Rules 1986, now replaced by rule 14.25 cited above, were announced by Lord Hoffmann in *MS Fashions Ltd v Bank of Credit and Commerce International SA (No.2)* (*BCCI No 2*)[56] and further elaborated in *Stein v Blake*.[57] The first of these is the *mandatory principle* which provides that if there have been mutual dealings before the winding-up order which have given rise to cross claims, neither party can provide or sue for his full claim.[58] An account must be taken and he must prove or sue for the balance. The second is the *retroactivity principle* in which the account is taken at the date of the winding-up order in the sense that the liquidation and distribution of assets of the insolvent company are treated as notionally taking place simultaneously on the date of the winding-up order. The third is the *hindsight principle* in terms of which in taking the account the court has regard to events which have occurred since the date of the winding-up. This affects also the valuation of claims and the taking of accounts.[59]

Complementary to the mandatory nature of insolvency set-off, it is also stated to be self-executing in the sense that there is no need for intervention of the parties for insolvency set-off to be executed. This self-executing nature of insolvency set-off has been put into doubt by a number of judg-

53 See GULLIFER (2017) 306; BENJAMIN (2007) 281. Issues regarding the justification of set-off will be discussed in Chapter 8.

54 See WOOD (2007) 32 for a list of common unprovable debts such as time-barred debts.

55 See VAN ZWIETEN (2018) 372.

56 [1993] 3 All E.R. 769.

57 [1996] 1 A.C. 243.

58 In *National Westminster Bank Ltd v Halesowen Presswork and Assemblies Ltd* [1972] A.C. 785 the reason given for the mandatory nature of set-off is that it is a matter of public interest in the orderly administration of the estate and not purely a source of private rights enacted for the benefit of individual debtors.

59 These principles are now clarified in the law by the Insolvency (Amendment) Rules 2005 (S.I. 2005/527) and reflected in rule14.25 of the Insolvency Rules 2016.

ments[60] of the English courts concerning the position of secured creditors and the interference of insolvency set-off with the enforcement of security. These judgments are mainly based on the interpretation of rules 14.24(6) and 14.25(1) of the Insolvency Rules 2016 which provide that insolvency set-off applies between a company and a 'creditor of the company proving or claiming to prove for a debt in liquidation'. If the interpretation to be given to this provision is that insolvency set-off only applies to debts owed by an insolvent if such debts are proved for, then this would imply that unless the secured creditor elects to surrender the security and to prove as an unsecured creditor, insolvency set-off would not apply to the secured amount. Although as already stated, there are conflicting judgments in this respect, such an interpretation would greatly indent the self-executing nature of insolvency set-off and would render it dependent on the will of the claiming creditor.

Before examining the basic requirements for insolvency set-off, an important distinction is made by English writers between executed and executory contracts in relation to insolvency set-off.[61] An executed contract is one which has been wholly performed by one party, leaving outstanding only the unperformed obligations of the other party, such as the repayment of a loan or withdrawal of a deposit. An executory contract is one in which obligations remain to be performed on both sides and the failure of either to complete performance would constitute a material breach, such as contracts for the exchange or delivery of money, including foreign exchange contracts or interest rate swaps. Van Zwieten opines that where all of the relevant contracts are executed and the claims on both sides are for money or are reducible to money, insolvency set-off will rarely be a problem since set-off in relation to existing liquidated claims, even if payable in the future, is straightforward.[62] Executory contracts, on the other hand, may involve the acceleration of obligations or the conversion of delivery obligations into monetary obligations or the conversion of foreign currency using methods not foreseen by the insolvency set-off rules. These are some of the features which have led to the contractual enhancement of set-off through close-out netting provisions to overcome the limitations set by insolvency set-off rules. In order to better understand these contractual enhancements, it is proposed to mention briefly the basic requirements of insolvency set-off and then compare them with those of close-out netting in part 4.2.2 below.

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60 For a debate on the conflicting judgments of the English courts in relation to the enforcement of security and the self-executing nature of insolvency set-off, see JAMES & KARAINDROU (2019) 228. See also McCRACKEN (2010). McCracken is of the view that since a secured creditor generally does not prove in insolvency, it should not be obliged to do so within the scope of the set-off provision. *Ibid.* 292.

61 See VAN ZWIETEN (2018) 384; WOOD (2007) 16. Wood refers to executed contracts as 'debts'.

62 VAN ZWIETEN (2018) 384.

Basic Requirements

Only rights and obligations which arise from mutual debts or mutual dealings may be the subject of a set-off, meaning that the respective claims should be owed between the same parties and these parties must be acting in the same capacity.[63] Thus, mutuality does not exist where one of the parties acts as agent for another and the counterparty attempts to set off an obligation with an obligation due by the agent in its personal capacity. In such circumstances, the set-off will be operable only against the underlying principal. It is not necessary that the claims should have arisen out of dealings between the parties if there are mutual debts. This would be the case if one of the debts which is subject to a proposed set-off has been acquired by the party asserting it in a set-off by way of an assignment from a third person[64] and by way of guarantee.[65] The techniques of assignment and cross-guarantees may also be used to manage risk exposure of affiliates belonging to the same group of companies.[66]

There is also a timing requirement. For set-off to be available in a winding-up, the relevant transaction must have been entered into prior to the commencement of the winding-up. This requirement extends only to a debt which is owing but not presently payable.[67] In addition, rule 14.25(6) of the Insolvency Rules 2016 provides that the claims that may be taken into account for set-off purposes do not include any debt that was incurred or acquired at a time when the creditor had notice of an impending insolvency or the commencement of insolvency proceedings or arises out of an obligation incurred during an administration which immediately preceded the liquidation.

For set-off to apply 'the sums due from one [party] must be set off against the sums due from the other'.[68] This implies that the claims in question must be monetary in nature, *i.e.* they must result in a liability to pay money. It is thus not possible to set off a claim for physical settlement such as the delivery of goods against a debt or an obligation to deliver identical

63 Multilateral set-off is therefore not permitted by rule 14.25 of the Insolvency Rules 2016. See ANNETTS & MURRAY (2012) 275.

64 DERHAM (2010) 284; Richard Tredgett, 'Chapter 12: England', in JOHNSTON *et al.* (2018), para 12.27 *et seq*

65 In *BCCI No 2* [1993] 3 All E.R. 769 Hoffman L.J. was prepared to give a wide interpretation to the mutuality arising by guarantee and held that even if the guarantor was not called upon to pay under the mortgage so that his liability remained contingent, however the wording of the mortgage-related documents was considered sufficient to create a liability vis-à-vis the guarantor.

66 WOOD (2007) 96 & 101.

67 In *Re Nortel Companies* [2013] UKSC 52 the court confirmed that a contingent debt arising out of a pre-existing contractual obligation qualifies as a claim under insolvency set-off.

68 Rule 14.25(2) of the Insolvency Rules 2016.

goods.[69] This limitation does not extend to obligations to deliver a foreign currency under a foreign exchange contract (which could be considered as a commodity bought and sold) since rule 14.21 of the Insolvency Rules 2016 provides a mechanism for converting the foreign debt into sterling.

It is no obstacle to the availability of set-off on a winding-up or administration that an obligation due to or from the company is contingent or only payable in the future.[70] In these circumstances, the liquidator must estimate its value and use the estimated value for set-off purposes. A contingent liability may give rise to a number of difficulties, the main one being that the relevant contingency might not materialise and the creditor would therefore have to give credit for an obligation that might never mature into an actual liability. The law in fact provides that if a net sum is due from the creditor, to the extent that it consists of a contingent debt, it will not be payable unless the contingency occurs.[71] However, in computing the net sum, any claim that the creditor would otherwise have against the company will be reduced by the value that has been placed on the contingent obligation, even if it subsequently turns out that it would never have become payable.

Finally, the mandatory nature of insolvency set-off implies that it replaces other forms of set-off upon the insolvency of one of the parties. But it does not replace the contractual provisions of a close-out netting clause, at least insofar as the close-out netting provision is protected under the provisions of the FCAR. Insolvency set-off is regulated by the provisions of insolvency law and as such parties to a set-off arrangement are not considered as contracting out of the insolvency rules, otherwise their arrangement could be held invalid by the courts. Close-out netting provisions, on the other hand, have been recognised under the FCAR, and prior to that under common law and equity, where they are treated as a permitted exception to the collective procedures of insolvency law. The brief overview made above of insolvency set-off indicates that it operates as a flexible instrument for the reduction of exposure between the parties and for this reason could have served for the protection of close-out netting provisions in the years preceding the FCAR. In the part below the constitutive elements of insolvency set-off and close-out netting will be compared in order to determine the contractual enhancement aspects of close-out netting. These contractual enhancements will then be viewed in the light of public policy and state insolvency goals in part 4.4 of this chapter.

69 FIRTH (2013), para 5.008.

70 Rule 14.25(7) of the Insolvency Rules 2016. The principle that contingent claims were included in set-off was not always consistently applied by the English courts until the matter was resolved in *Secretary of State for Trade and Industry v Frid* [2004] 2 AC 506. See Richard Tredgett, 'Chapter 12: England', in JOHNSTON *et al.* (2018), para 12.20.

71 Rule 14.25(8) of the Insolvency Rules 2016.

4.2.2 Insolvency Close-out Netting and Insolvency Set-off Compared

It may be difficult to draw a line of demarcation between the concepts of insolvency close-out netting and insolvency set-off given that insolvency set-off is widely applied and interpreted under English law. The close relationship between the two concepts is evident in opinions expressed by authors even though these opinions may at times vary on the extent of this relationship. Thus, Hudson makes the statement that 'close-out netting is dependent on the general law on insolvency set-off' which, although rather ambiguously worded, may imply that where the conditions of insolvency set-off are satisfied, the close-out netting provisions will be regulated by insolvency set-off rules and not the FCAR.[72] Firth, on the other hand, whilst acknowledging that close-out netting is often spoken of 'as an application of the law of set-off', if no set-off is involved, then an agreement should not be struck down on the basis that it does not satisfy the requirement for set-off to be available.[73] Henderson takes the discussion a step further and notes that close-out netting is not set-off since it is the valuation of a whole agreement and is not the consideration of the value of a liability against another, even though he admits that courts might analogise close-out netting to set-off, based on considerations of public policy.[74]

A comparison between the concepts of insolvency set-off and close-out netting may lead to a better appreciation of the relationship between these two concepts. Under English law this relationship is rather critical since once the conditions of insolvency set-off materialise, insolvency set-off rules will have to be adhered to for close-out netting to be effective. The comparison of the various features of the two concepts will also help determine the contractual enhancement aspects of close-out netting as recognised under the FCAR which distinguish it from insolvency set-off. First the scope of application will be considered, followed by a comparison of the basic requirements and other features.

Scope of application

Both the insolvency set-off rules and the FCAR provisions have a wide material scope of application. Neither of these regimes depend on the transactions being of the same kind. However, whilst there appears to be no limitation to the type of obligations that may be set off provided these are provable in an insolvency, the FCAR only contemplates the close out of 'relevant financial obligations' applicable in relation to financial collateral

72 HUDSON (2018) 17-58.

73 Set-off would be involved where, for instance, payments that were unconditionally due to be made prior to termination of a close-out netting arrangement are taken into account in calculating the close-out amount as they may be considered to constitute separately enforceable debts. See FIRTH (2013), para 5.067.

74 HENDERSON (2010) 481.

arrangements.[75] The FCAR definitions do not as such limit the type of obligation but it is understood that this must be an obligation which could be the subject of a financial collateral arrangement. Thus, it would exclude obligations under tort or damages which may be considered under set-off. The question arises whether obligations beyond the remit of the FCAR may be considered for the purposes of insolvency close-out netting. The FCAR consultation document declares that there are no restrictions under English law to prevent the enforcement of close-out netting provisions in accordance with their terms[76] so that the limitation to 'relevant financial obligations' may arise solely as a consequence of the fact that the FCAR implements the EU's Financial Collateral Directive. This appears to be also contemplated by the definition of 'netting arrangements' in the Banking Act which refers generally to 'claims or obligations'. However, the definition of the Banking Act is arguably intended to serve for reference purposes and is not meant to regulate the parameters of the concept of close-out netting.

The personal scope of both concepts is also widely construed. Thus, insolvency set-off applies to individuals and corporates, whilst close-out netting under the FCAR applies to non-natural persons. As already seen in part 4.1 of this chapter, the FCAR consultation document states that close-out netting under English law may also be availed of by individuals, however since the FCAR has been issued under enabling powers of section 2(2) the European Communities Act 1972, it did not appear appropriate to extend the FCAR to individuals. Hence, there is rather a technical, and not a substantive, reason why the FCAR provisions have not been extended to individuals, though the legislator presumes that close-out netting provisions entered into by individuals are also protected under English law, presumably if they comply with the provisions of insolvency set-off.[77]

Basic Requirements

First, mutuality is a requirement which must be satisfied for both insolvency set-off and close-out netting to be available. There is nothing in the provisions of the FCAR which requires that there are mutual debts between the parties to a close-out netting provision, as is required by rule 14.25 of the Insolvency Rules 2016. Fawcett, whilst noting that the FCAR are silent about the requirement of mutuality in close-out netting, notes that it would be against public policy in England to exclude mutuality and if the legis-

75 See the definition of 'close-out netting provision' in combination with the definitions of 'financial collateral arrangement', 'title transfer financial collateral arrangement' and 'security financial collateral arrangement' in Article 3 of the FCAR.

76 HM TREASURY 2003 FCAR Consultation Document, paras 1.12 & 5.9.

77 This presumption is supported by the statement made by the English legislator in the FCAR consultation document that, in relation to the implementation of Article 7(1) of the EU Financial Collateral Directive, rule 4.90 (now rule 14.25 of the Insolvency Rules 2016) continues to apply to financial collateral arrangements. HM TREASURY 2003 FCAR Consultation Document, para 5.9.

lator had intended to exclude mutuality then the intention would have been more clearly stated.[78] Hudson opines that there must still be mutual debts under the FCAR since for there to be a financial collateral arrangement, there must be some provision of cash or securities to cover the relevant financial obligations owed to the secured party by the debtor.[79] The same argument is made by Gullifer who states that the FCAR addresses 'parties' to a financial collateral arrangement and is intended to implement the FCD which refers to bilateral close-out netting provisions in its recital (14).[80] An important distinction is made by Firth in the fulfilment of the mutuality requirement between insolvency set-off and close-out netting. Firth states that mutuality may become problematic in insolvency set-off where the insolvent company has physical settlement obligations which the liquidator elects to perform, since it does so in a new interest and a new capacity, so that any mutuality is destroyed and the transaction cannot therefore be brought into account. However, according to Firth, if in a close-out netting arrangement there is a so-called 'flawed asset' provision, implying that if the solvent company is in default the other party can refuse to perform and a close-out takes place, a net exposure should be achieved even if the set-off arrangements are unenforceable.[81] The fulfilment of the mutuality requirement may be problematic in inter-group or multilateral arrangements for both concepts. As mentioned in part 4.2.1 of this chapter, inter-group set-off and netting is ineffective on the insolvency of one of the companies since the claims would not be mutual, unless mutuality is created by each company guaranteeing the others' claims. This would be analogous to the situation in *Re BCCI No 2*. In the same vein, the type of bilateral netting provisions recognised under the FCAR does not contemplate a multilateral type of netting of the sort contemplated by the *British Eagle* case.[82]

Second, under both set-off and close-out netting, obligations must be of a monetary nature. Whilst in set-off a stricter interpretation is applied in the sense that non-monetary obligations, such as delivery obligations, may only be considered if they can be given a monetary value,[83] in close-out

78 FAWCETT (2005) 296.

79 HUDSON (2013) 1250.

80 GULLIFER (2017) 386.

81 FIRTH (2013), paras 5.011 & 5.060. The same argument has been resorted to by van Zwieten in the discussion on executed and executory contracts made in part 4.2.1 when stating that obligations under executory contracts cannot be set off since the unperformed contract is taken over by the liquidator and hence mutuality no longer exists.

82 However, recognition of multilateral netting schemes regarding investment exchanges and clearing houses has been granted under the Financial Services and Markets Act 2000 and the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (S.I. 1999/2979). In these instances, the novation of transactions forms the basis of many multilateral netting arrangements, whereby transactions entered into between the members of a clearing system to a central clearing house are novated in order to create mutuality between each party's rights and obligations. See FIRTH (2013), para 5.035.

83 This is in accordance with rule 14.25(2) which provides, *inter alia,* that 'sums due from one [party] must be set off against the sums due from the other'.

netting no such restriction applies so long as the close-out netting arrangement provides a method to terminate any outstanding delivery or other settlement obligations and replace them with an obligation to pay a sum of money. According to Firth this would be the case regardless of whether the delivery obligations were due to have been performed before or after the termination date as long as on insolvency an obligation to pay a cash sum arises in their place.[84] In addition, both the insolvency set-off and close-out netting regimes foresee a liberal conversion of foreign currency. Whilst rule 14.21(2) of the Insolvency Rules 2016 requires the conversion of all debts into sterling at a single rate for each currency determined by reference to the exchange rates prevailing on the relevant date, regulation 14 of the FCAR does not impose the conversion of the monetary value of the debt into sterling and permits the exchange rate mechanism foreseen for the conversion of foreign currency in the netting agreement provided this is not an unreasonable exchange rate.

Third, it has been seen that in relation to insolvency set-off, rule 14.25(8) of the Insolvency Rules 2016 contains a mechanism for valuing contingent debts and requires that any future obligations be discounted at a prescribed rate. If the contingent debt cannot be estimated by the set-off rules, its value may be estimated. This valuation may be subject to revision if considered inaccurate. Close-out netting agreements seek to circumvent these requirements by converting any contingent or future obligations into a present obligation, through termination or acceleration of its maturity, to pay the net sum calculated in accordance with the valuation terms of the agreement.[85] It is typically the case that the valuation is done by the solvent party, designated as the 'non-defaulting party' in the applicable master agreement. The close-out netting valuation process also permits taking into account certain costs which would not normally be considered in the valuation of contingent debts in set-off, such as losses relating to the hedging of transactions.[86]

Fourth, in part 4.2.1 it is stated that set-off only applies in respect of executed contracts, whilst close-out netting may apply in respect of executory contracts since it involves the termination or acceleration of obligations of both parties.[87] Thus, whilst the insolvency set-off rules foresee the possibility of valuing contingent and future debts which become fully effective once these debts mature, it does not provide for the possibility of the parties

84 FIRTH (2013), para 5.069.

85 In terms of the ISDA English Law Opinion, 'To include contingent debts within the scope of close-out netting it is simply necessary to provide a method for valuing such debts.' *Ibid.* p 25.

86 The reason for this distinction may actually be more practical than academic since hedging is more typically associated with executory, rather than executed, contracts. Moreover, Hudson sheds some doubts on the readiness of the courts to accept the inclusion of hedging costs in the close-out netting valuation and recommends that their acceptance may be better guaranteed if their calculation methodology is specified in the master agreement. HUDSON (2018) 17-65.

87 For a list of examples of executed and executory contracts, see WOOD (2007) 16.

to terminate or accelerate outstanding transactions. Van Zwieten notes that where contracts on both sides are still executory at the time of winding up, the solvent party is exposed to the risk of cherry-picking by the liquidator, leaving the solvent party to prove in the winding up for damages.[88] The solution has been provided by the close-out netting mechanism whereby all executory contracts are automatically terminated or closed out in the event of either party going into liquidation, assisted by the application of the single agreement concept whereby all transactions between the same parties are deemed to form part of the same agreement.[89] Hudson, on the other hand, argues that the approach of the English courts has been that if the parties can put a value on the entire executory contract, then that amount can be set off. However, the case cited by Hudson to substantiate this claim[90] refers to the possibility to place a value on future, contingent obligations in credit card use, rather than on executory contracts where both parties still have to perform their obligations.[91] The issue of valuing contingent debts is, arguably, a different issue which is still considered under the purview of executed contracts and Hudson's interpretation of the situation does not take into account the cherry-picking argument made by van Zwieten but only considers whether it is possible to value the unperformed obligations.

The above comparative overview of the basic requirements and features of insolvency set-off and close-out netting indicate that the contractual enhancement features of close-out netting have served to formulate a risk-reduction mechanism which meets the requirements of the financial markets. Prior to the advent of the FCAR, the insolvency set-off rules may have been considered to be sufficiently flexible in order to accommodate close-out netting provisions under English law. This has been confirmed, amongst others, by the Statement of Law on 'Netting of Counterparty Exposure' issued by the UK Financial Law Panel in 1993 confirming the enforceability of close-out netting provisions under English law as well as the FCAR consultation document declaring that there are no restrictions under English law which need to be removed to implement Article 7 of the EU's Financial Collateral Directive in order to enforce close-out netting provisions. The FCAR consultation document also declares that it is understood that insolvency set-off rules under (the former) rule 4.90 of the Insolvency Rules 1986 will continue to apply to financial collateral arrangements.

88 See section 178 of the Insolvency Act 1986.

89 VAN ZWIETEN (2018) 385.

90 *Re Charge Card Services* [1987] Ch 150. Hudson quotes Millett J when he states:

> 'By the turn of the [20th] century, therefore, the authorities showed that debts whose existence and amount were alike contingent at the date of the receiving order, and claims to damages for future breaches of contracts existing at that date, were capable of proof and, being capable of proof, could be set off under the section provided that they arose from mutual credits or mutual dealings. The only requirement was that they must in fact have resulted in quantified money claims by the time the claim to set off was made.'

91 HUDSON (2018) 17-103.

This may lead to the question whether English law actually distinguishes between the two concepts or whether the FCAR is merely declaratory of the existing legal regime? It could be argued that given the wide application of insolvency set-off under English law, it was deemed that there are no substantive restrictions which could hamper the enforceability of insolvency close-out netting provisions. However, this approach does not take into account, among other contractual enhancements, the important distinction made between executed and executory contracts, and the possibility to terminate outstanding transactions which is only possible under a statutory recognised close-out netting provision. Thus, notwithstanding the flexibility with which insolvency set-off rules have been operated (and indeed there are relatively few contractual enhancements under English law when compared to the other two selected regimes), termination is not foreseen in these rules so that rule 14.25 of the Insolvency Rules 2016 only permits the setting off upon insolvency of individual transactions in relation to executed contracts. Executory contracts, on the other hand, are generally intended to govern an entire business relationship between two parties or, alternatively, a series of transactions to be concluded over a relatively long duration which may be closed out prematurely on the happening of a trigger event. This type of contracts, which may include master agreements, are ideally suited to govern business relationships in certain markets, most typically the financial markets, as they render business relationships efficient, serve to reduce counterparty exposure, safeguard against unhedged open positions and, depending on the prevailing circumstances, may prevent or mitigate systemic risk. Thus, whilst it may be the case that English law may not draw a distinction in the regulation of set-off or close-out netting of obligations in relation to an executed contract where the conditions of insolvency set-off concur so that in these cases rule 14.25 of the Insolvency Rules 2016 may be construed to apply to both concepts (since this rule is mandatory and self-executing), the FCAR is arguably necessary to protect the enforceability of close-out netting in relation to executory contracts and in respect of the other contractual enhancements considered above. To the extent that the insolvency set-off conditions are not met in relation to an executed contract, there seems to be no statutory restriction why a close-out netting provision may not benefit from recognition under the FCAR if the provisions of the latter are fulfilled.

The legal situation, however, was different prior to the FCAR. Thus, in *British Eagle* the court was not prepared to give a wide interpretation to the insolvency set-off provisions to recognise the efficiency created by the executory-type of arrangement adopted by the airline operators through IATA for the settlement of their payments on a multilateral basis, since this arrangement could not be rescinded under applicable rules, the mutuality aspect was deemed missing and the arrangement was considered to amount to a contracting-out of the *pari passu* rule. In *BCCI (No 2)*, on the other hand, the courts were prepared to give a wide interpretation to the mutuality requirement in an executed-type of contract by accepting that a guarantor could be allowed to set off personal claims against the debts of the company which he guaranteed as this was deemed to be a just outcome to the situation. Thus, the development of insolvency close-out netting and its use as an instrument not only for market efficiency and for the reduction of counterparty exposure, but also to allow for the development of new financial instruments and to protect against systemic risk, may have given a new meaning to the protection of executed and executory agreements under the FCAR which might not have been originally contemplated in 2003 when these Regulations were adopted. On the other hand, close-out netting agreements not falling within the remit of the FCAR, such as those between sole traders or not related to a financial collateral arrangement, the protection of the FCAR is not available and these will need to fulfil the requirements of the insolvency set-off rules which, as seen above, are relatively more strict to satisfy and are restricted to executed agreements as technically they do not foresee the termination or acceleration of outstanding transactions.

4.3 The Recognition of Close-out Netting Provisions Before and After the Adoption of a Bank Resolution Regime

As already described in part 4.1 of this chapter, there are three important elements related to the recognition of close-out netting provisions under the FCAR. First, in regulation 12(1) it is stated that a close-out netting provision is to take effect 'in accordance with its terms' and this notwithstanding the commencement of winding-up proceedings or the taking of reorganisation measures. Regulation 12(1) of the FCAR implements the provisions of Article 7(1)(a) of the EU's FCD. The primary close-out netting rule under English law is therefore to respect contractual freedom in the applicability of close-out netting provisions even upon the institution of insolvency proceedings.

Second, under regulation 12(2) recognition is not granted to close-out netting provisions if the solvent party had actual or constructive knowledge of the insolvency or imminent insolvency of the other party. Regulation 12(2), on the other hand, is a 'home-grown' provision and has arguably been included on the basis of recital (15) of the FCD which permits the imposition of certain national law restrictions.

Third, the FCAR disapply certain provisions to ensure the enforceability of close-out netting provisions. Thus, regulation 10(1)(b) disapplies section 127 of the Insolvency Act 1986 on avoidance measures, regulation 12(4) disapplies certain (former) provisions on insolvency set-off in relation to close-out netting provisions and regulation 14 provides that the currency conversion standards of the insolvency set-off rules do not apply provided the financial collateral arrangement provides for a reasonable exchange rate. This state of affairs is rather enigmatic since it raises the question whether this implies that other provisions on insolvency set-off will therefore invariably apply. There are conflicting views on this issue[92] but the view taken in this research is that the reference made to certain provisions of the Insolvency Rules is not to be interpreted that other insolvency set-off provisions will apply to close-out netting unless, as noted above, the conditions of insolvency set-off are met prior to bringing the close-out netting provision into effect and then rule 14.25 of the Insolvency Rules 2016 becomes mandatory and self-executing. This would conform with the view of the legislator expressed in the FCAR consultation document that specific disapplications from insolvency law were only made in those cases where doubts arose as to their applicability as otherwise it was considered there were no obstacles to the enforcement of close-out netting provisions in accordance with their terms.[93]

Regulation 12 has given rise to interpretation problems on whether insolvency set-off rules may still apply in cases where insolvency set-off conditions are met, notwithstanding that the provisions of regulation 12 apply in respect to a particular close-out netting provision. Ho offers two interpretations to the configuration of regulation 12.[94] The first is that unless the situation falls within the exclusions of regulation 12(2), a close-out netting provision takes effect as a matter of contract and the statutory set-off rules have no role to play. The second interpretation, favoured by Ho, is that in the circumstances where the insolvency set-off rules apply, a close-out netting provision would always give way to the application of insolvency rules. Gullifer considers that the FCAR provisions 'support the view that insolvency set-off is displaced by the contractual scheme, and this also has the benefits of consistency with the other carve-outs'. According to Gullifer it is therefore no longer required to ensure that the close-out netting provision is formulated on the basis of insolvency set-off rules or, alternatively, that it is drafted in a way which avoids resort to set-off, such as by using novation.[95] Of a contrary view are Yeowart *et al.* who consider that regulation 12 cannot be considered as preventing the operation of insolvency set-off if, before the close-out netting provision is brought into effect, the administrator gives notice of a distribution or an order is made for winding-up.

92 Derham and Ho agree that insolvency set-off rules in general do not apply when a close-out netting arrangement is regulated by Regulation 12 of the FCAR. See DERHAM (2010) 769; HO (2012) 351. However, Firth proposes that regulation 12(4) is to be interpreted to the effect that the rest of rules 14.24 and 14.25 of the Insolvency Rules 2016 do apply to close-out netting arrangements 'so that the requirement for close-out netting provisions to take effect in accordance with their terms is intended to be subject to these rules.' See FIRTH (2013) paras 6.035 & 6.036. Of the same view are Yeowart *et al.* in YEOWART *et al.* (2016) 233.

93 HM TREASURY 2003 FCAR Consultation Document, paras 5.9, 5.12 & 5.13. The ISDA English Law Opinion also confirms that there is a remote likelihood that if close-out netting does not occur before commencement of liquidation, it would be replaced by the statutory insolvency set-off provisions. *Ibid.* 27.

94 HO (2012) 351.

95 GULLIFER (2017) 387.

Although acknowledging that this goes against the spirit of the FCD of having in place a robust close-out netting regime, they state that there is nothing in regulation 12 to disapply rules 14.24 and 14.25 of the Insolvency Rules 2016 in their entirety.[96] While the view has already been expressed above that the specific disapplication of certain provisions of insolvency law should not be taken to mean that the other provisions are deemed to apply, however considering the mandatory nature of the insolvency set-off rules it is opined that if the administrator or liquidator brings into force the insolvency rules before the trigger of a close-out netting provision, then the insolvency set-off rules will apply. This seems to be confirmed by the UK legislator in the FCAR consultation document where it is stated that 'Rule 4.90 will continue to apply to financial collateral arrangements, and there is no need for the regulations to make specific mention of this'.[97]

The regulation of close-out netting prior to the financial crisis is broadly reflected in the provisions cited above. After the financial crisis, regulation 12(5) was added to the FCAR to provide that nothing prevents the Bank of England imposing a restriction on the effect of a close-out netting provision in the exercise of resolution powers under the Banking Act.[98] It has been seen above that the definition of reorganisation measures does not include resolution measures taken under the Banking Act so that the freedom of the parties to close out an executory contract in this circumstance is not foreseen or is not enforceable under the FCAR. It would thus seem that this provision is either superfluous or seeks to establish a link between the Banking Act and the FCAR insofar as concerns their respective close-out netting provisions.[99] This is arguably the case so as to establish a hierarchy between the provisions of the FCAR and the Banking Act and to ensure that the implementation of a close-out netting provision under the FCAR does not frustrate, in any possible residual way, the implementation of resolution measures.

Resolution Measures

In its original version, the Banking Act did not contain substantive provisions on close-out netting. Of relevance to netting were two enabling provisions, namely sections 47 and 48, still in existence, which empowered the Treasury to make orders to impose restrictions on the exercise of resolution powers to make partial transfers[100] and to protect security interests, title transfer collateral arrangements and rights of set-off and netting, including

96 YEOWART *et al.* (2016) 232.

97 HM TREASURY 2003 FCAR Consultation Document, para 5.9.

98 Regulation 12(5) of the FCAR was added by the Bank Recovery and Resolution (No. 2) Order 2014/3348 Sch. 3(3) (S.I. 2014/3348).

99 This may be similar to the link established between the EU's FCD and BRRD through, for instance, Article 2(1)(98) of the BRRD.

100 Section 47 of the Banking Act 2009.

close-out netting, which might be adversely affected by a partial property transfer in respect of partial property transfers.[101] The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009[102] purports to give effect to these matters. In 2014 the Bank Recovery and Resolution Order 2014[103] brought a number of amendments to the Banking Act 2009, which, in terms of the Explanatory Note attached to this Order, were intended to 'align existing provisions with the requirements of the RRD [EU Bank Recovery and Resolution Directive] and create new powers for the Bank of England required by the RRD'. Further finetuning took place by means of the Bank Recovery and Resolution Order 2016.[104]

There are three main types of restrictions which may be imposed under the Banking Act 2009 in relation to close-out netting arrangements, namely suspension of the exercise of termination rights, exercise of the bail-in provision and transfer of assets. Since the applicability of the Banking Act is restricted to banks and certain investment firms, these restrictions do not affect other institutions or corporations whose agreements are protected by the FCAR.[105] Since the Banking Act was adopted prior to the BRRD, it will be noted below that these restrictions underwent substantial amendments to converge with the provisions of this EU Directive. The effect of each of these measures on the enforceability of close-out netting provisions under the party autonomy principle is examined below.

Suspension of Termination Rights

It has been stated above that an important contractual enhancement of the close-out netting concept is the recognition of the option of the parties to terminate executory contracts on the occurrence of a trigger event. In addition, it has also been noted that the Banking Act 2009 applies to any type of close-out netting arrangement, and not solely to those falling within the scope of the FCAR. Termination rights of netting arrangements, whether or not these are regulated by the FCAR, are affected by section 48Z of the Banking Act 2009 which provides that a crisis management measure or a crisis prevention measure as defined under the same article, is to be

101 Section 48 of the Banking Act 2009.

102 S.I. 2009/322.

103 S.I. 2014/3329.

104 S.I. 2016/1239. This Order brought, *inter alia*, finetuning amendments to section 48Z of the Banking Act 2009 on 'Termination Rights etc.'.

105 It will be recalled that close-out netting agreements concluded between corporate entities are also protected under the FCAR. These are not captured by the Banking Act 2009 but may, however, be ultimately affected by the stay of individual enforcement actions imposed under Articles 6 and 7 of the proposed Directive (EU) 2019/1023 of the European Parliament and of the council of 20 June 2019 on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132 (Directive on restructuring and insolvency) [2019] OJ L 172/18, since they are not excluded parties under Article 1(2) of the same Directive.

disregarded in determining whether a default event provision in an agreement applies, provided that 'the substantive obligations provided for in the contract or agreement (including payment and delivery obligations and provision of collateral) continue to be performed'. This proviso, as well as the reference to crisis management and crisis prevention measures, were lacking under the original version of this rule as appearing in former sections 22[106] and 38[107] of the Banking Act 2009 and were introduced to transpose the BRRD. The effect of this provision is that whilst termination is not possible on the basis of the taking of resolution measures, yet termination is still protected and may be enforced if the party under resolution is in breach of substantive obligations such as delivery and payment obligations and the provision of collateral.[108]

Section 70C on the suspension of termination rights has been added to the Banking Act 2009 in order to implement the BRRD. 'Termination right' is defined in section 70C(10) to refer, *inter alia*, to the right to terminate a contract and the right to accelerate, close out, set off or net obligations. A similar provision did not exist in the original version of the Act so that the legal position in relation to termination rights before the BRRD was that the law set restrictions on the exercise of termination rights in relation to specific resolution measures without subjecting these to the continued performance of obligations under the netting arrangement. Therefore, the rights of creditors under netting arrangements are more adequately protected under the current law. Similar to the position under the BRRD, section 70C imposes restrictions on termination rights which are accompanied by safeguards intended to protect the rights of the solvent party. The principal restriction is that the Bank of England may suspend the exercise of termination rights which suspension is effective upon the publication of the relevant instrument of suspension and ends no later than midnight at the end of the first business day following the day of publication of the instrument. The safeguards provided are firstly that the bank under resolution should continue to perform substantive obligations under the agreement. Second, the solvent party is able to exercise termination rights before the expiry of the suspension if given notice by the Bank of England that the

106 Dealing with transfer of securities.

107 Dealing with transfer of property. A similar provision was made in section 48M, added by section 4 of the Financial Services (Banking Reform) Act 2013, when the bail-in option was introduced.

108 Whilst the Banking Act 2009 seeks to maintain a balance between the imposition of restrictions and the provision of safeguards, Gleeson and Guynn note that the various instruments and orders that may be issued which, for instance, specify that default event provisions are to be disapplied are significant since they could alter the contractual expectations of the parties. They state that these disapplication powers have changed attitudes about the effectiveness of early termination and close-out netting provisions under English law where one of the parties is a bank and this is being noted by English lawyers when providing legal opinions on agreements such as the ISDA master agreement. See GLEESON & GUYNN (2016) 264.

contract will not be transferred or will be subject to a mandatory reduction instrument or a resolution instrument. Third, termination rights may be exercised after the suspension if triggered otherwise than through the exercise of a stabilisation power or the imposition of a suspension. Finally, in order to ensure due observance of systemic risk, the Bank of England is to have regard to the impact which a suspension might have on the orderly functioning of the financial markets.

Partial Transfers

A partial property transfer exercised in relation to a netting contract disrupts both the single agreement concept and also the close-out netting mechanism since it splits up the various transactions covered by the close-out netting provision. In order to prevent this, special protection is afforded to, amongst other interests, netting arrangements. The Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the 2009 Order) imposes an obligation on the Bank of England to transfer complete netting packages. The 2009 Order applies in respect of netting arrangements as defined in section 48(1) of the Banking Act and, for the avoidance of doubt, article 1(4) provides that the reference to netting arrangements covers also netting arrangements under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 and close-out netting provisions under the FCAR. The prohibition of a partial property transfer is extended to netting arrangements concluded between a person and a banking institution. This may therefore include individuals who, as seen above, are excluded from the scope of the FCAR. The rationale behind this is arguably that the 2009 Order intends to protect any netting arrangement concluded with a bank and not solely those falling within the scope of the FCAR.[109] Further safeguards are provided in article 3(2) whereby a partial property transfer may not include provision under the continuity powers[110] which terminates or modifies the protected rights or liabilities between the parties to a netting arrangement, whilst under article 3(3) rights and liabilities are protected in so far as they are not excluded rights and liabilities in terms of article 1(3) of the 2009 Order. The end result of this exclusion is that this may disrupt certain master netting arrangements which include cross-product netting where one of the amounts to be netted is an excluded right or liability but otherwise keeps intact the close-out netting of those liabilities which are included in the protection against

109 The consequence of this is that a netting arrangement where one of the parties is an individual will then be subject to the rules on insolvency set-off for its validity. This may leave room for doubt about the protection of rights and liabilities arising out of these netting arrangements concluded by an individual with regard to executory contracts since they are protected by neither the FCAR nor rule 14.25 of the Insolvency Rules 2016, with the result that they may be considered as an invalid means of contracting out of the insolvency rules.

110 Continuity powers are defined under section 64(2) of the Banking Act 2009.

partial transfers.[111] Concerns were also allayed that the resolution authority would be able to 'cherry pick' which assets and liabilities to transfer, thus leading to arbitrary and unfair results.[112]

Bail-in Provision

In terms of section 48B of the Banking Act and the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014 (the 2014 Order), the Bank of England may bail in certain liabilities relating to derivatives, financial contracts and qualifying master agreements.[113] The exercise of bail-in powers may lead to the cancellation or modification of a liability of a bank under resolution or of a contract in relation to that liability.[114] Since derivatives, financial contracts and qualifying master agreements benefit from greater protection in insolvency due to set-off and netting rights related to them, these are respected under bail-in, thus ensuring that creditors are not treated worse than they would have been in insolvency.[115] Therefore, where a protected liability in terms of this Order relates to a derivative, financial contract or a qualifying master agreement, it must be converted into a net debt, claim or obligation before it can be bailed in.[116] In terms of article 4(6), the conversion into a net amount may be done either in accordance with the provisions of the relevant netting arrangement or by an estimate of the net

111 As confirmed in the ISDA English Law Opinion, the prohibition also covers secured transactions so that a secured asset may not be separated from the liability it secures under a partial transfer. *Ibid.* p 110.

112 YEOWART *et al.* (2016) 111.

113 All terms are defined in article 5 of the Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014. Connelly criticises the way the legislator has defined certain terms with the result that certain mismatches in the definitions under the 2014 Order from those of the BRRD and the FCAR have left some types of arrangements uncovered by this Order. In brief, Connelly notes that the definition of 'derivative' refers to Article 2(5) of *Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories*, [2012] OJ L 201/1 and seems to exclude from the protection of article 4(1) spot transactions such as foreign exchange spot transactions. Connelly also criticises the fact that the definition of netting arrangements refers to the definition given in section 48P(2) of the Banking Act which ignores the existing English law definitions such as those found in the FCAR. Although Connelly admits that section 48P(2) may be given a purposive interpretation, it is not as wide as the FCAR interpretation which covers the three types of netting typically used to close out transactions under the market standard master agreements, namely acceleration of obligations, termination and taking account of all sums due, with the creation of an obligation to pay a sum equal to the net sums due. See CONNELLY (2015) 81.

114 Section 48B(1) of the Banking Act 2009.

115 HM TREASURY 2017 SRR Code of Conduct, para 8.27.

116 It is noted in the ISDA English Law Opinion that unsecured liabilities are not protected in terms of article 4(3) of the 2014 Order. It is therefore recommended that an ISDA Credit Support Document is entered into to ensure protection of the close-out netting mechanism. *Ibid.* 117. This understanding is in line with the protection given solely by the FCAR to close-out netting provisions which form part of a collateral financial arrangement or are related to it.

amount by the Bank of England in the special bail-in provision. This power could be used to convert the right into a net debt. Following this conversion, the net claim can be bailed in in the same way as the bank's other liabilities. According to the Banking Act code of practice, '[t]hese contracts need not be closed out prior to bail-in, or treated as if they had been closed out […] they remain protected by the "No shareholder or creditor worse off" safeguard which will take into account any set-off or netting rights that would have been respected in insolvency'.[117] The special bail-in provision therefore does not foresee the close-out of netting arrangements but solely the determination of a net amount in order to ensure observance of the no creditor worse-off principle. This implies that the contracts continue in existence but the bail-in may affect the actual amount which the solvent counterparty may recoup.

4.4 Rationale of English Insolvency Law

It has been stated in part 4.1 that as a common law jurisdiction English law considers favourably pre-insolvency contractual entitlements. Close-out netting, similar to insolvency set-off, may be considered as a type of such contractual entitlement which is recognised as effective upon the insolvency of a counterparty. Notwithstanding this recognition, close-out netting remains an exception to the collective nature of English insolvency law and, in particular, an exception to the *pari passu* principle. The interaction of the recognition of close-out netting rights with the rationale of English insolvency law will be considered in this part.

Fletcher states that English insolvency law pertains to those systems of insolvency administration which offer a collective approach whereby a uniform method is applied in the final administration and distribution of the debtor's property to calculate the abatement which will be experienced by all claims of unpaid creditors who are ranked in common together under the *pari passu* principle. Fletcher further states that English insolvency law embodies a number of value judgments about the relative priority of the various kinds of liabilities owed by an insolvent debtor, and of the order in which these groups of liabilities should be discharged out of the limited funds available for the purpose. However, there is no equality among creditors under English law so that defined groups of creditors are accorded preferential status or enjoy some kind of privilege. These creditors enjoy improved prospects of repayment by comparison with the general body of creditors.[118]

117 HM TREASURY 2017 SRR Code of Conduct, para 8.32. Gleeson and Guynn state that the protection of article 4 of the 2014 Order 'is only available prior to the agreement's being closed out – when the claim arising under the agreement has been converted into a net debt, that claim may be bailed in. Such conversion may be effected by the resolution instrument itself, but it remains the case that netting under un-closed-out masters will be respected.' GLEESON & GUYNN (2016) 309.

118 FLETCHER (2017) 1-006.

A significant change in philosophical approach in insolvency law was brought about by the Enterprise Act 2002 with the introduction of a rescue culture towards the insolvent debtor and the institution, amongst others, of the administration procedure.[119] Following this shift in philosophical culture, Finch states that there are currently two strong threads of concern in English insolvency law namely to establish formal legal procedures for business rescue and the orderly realisation and distribution of assets, and to erect a regulatory framework that would prevent commercial malpractice and abuse of the insolvency procedures. Finch also notes a new emphasis on managing insolvency risks proactively rather than after troubles have become crises such as by means of the 'pre-packaged' administration.[120]

The recent financial crisis resulted in a further shift in approach. It has been recognised that the failure of banks may give rise to systemic risk. The failure of a large bank can have a domino effect leading to the collapse of the entire banking market as they may have substantial exposure to that bank through inter-bank lending. Failures of banks also have a great impact on depositors who may proceed to a bank run. It has been seen that the solution adopted by the UK Government to the crisis in legislative terms is by introducing the Banking Act 2009. This has changed the collective procedure for handling failures insofar as banks, and with the Investment Bank Special Administration Regulations[121] also investment banks, are concerned. Under the Banking Act banks undergo a special resolution regime when they are in or are approaching financial difficulty so that the trigger for the resolution of banks is a regulatory one as opposed to balance sheet or cash flow insolvency. Also, in line with modern resolution regimes, the judicial process of dealing with a failing bank has been largely replaced by an administrative process.

By way of preliminary analysis, the question arises as to how creditors benefiting from close-out netting rights feature under English insolvency law. Enforceable close-out netting arrangements grant preferential status to netting creditors and are only subject to the *pari passu* principle to the extent of the net amount which remains owing following the calculation of the close-out amount. Given the measure of self-help afforded to netting creditors, it is also the case that a liberal approach in the enforcement of close-out netting provisions would go contrary to the business rescue culture instilled by the Enterprise Act.[122] Considerations of financial stability taken from the perspective of a failing bank have brought significant erosion in

119 DTI 2001 Insolvency Consultation Document.

120 FINCH & MILMAN (2017) 15 *et seq*.

121 S.I. 2011/245.

122 As reiterated in part 4.3, the proposed Restructuring Directive would ensure that certain agreements such as close-out netting agreements concluded by two corporate entities none of whom is a financial institution will be subject to the stay from termination and execution of the agreements under Article 6 of this Directive and this would somewhat reinstate the business rescue culture between such entities.

the enforceability of close-out netting provisions in terms of the Banking Act 2009. Notwithstanding any applicable restrictions, the law provides protection to the rights of solvent netting creditors since, after all, these rights were initially granted for the sake of protecting against systemic risk and thus the law aims to achieve a balance between protecting financial stability and bank depositors on the one hand, and safeguarding the close-out netting mechanism on the other. Indeed, in one instance, namely in the case of suspension of termination rights under section 70C(4) of the Banking Act, the Bank of England is obliged to have regard to the impact which a suspension might have 'on the orderly functioning of the financial markets' before imposing a suspension, presumably since systemic risk and considerations of financial stability may also arise if the solvent creditor is restricted from exercising netting rights.

4.4.1 Principles Upheld by English Insolvency Law

English law recognises various principles which have shaped the application and interpretation of English insolvency law, a few of which have been mentioned in part 4.1 of this chapter. The following principles are considered the most relevant for the purposes of this research since they address pre-insolvency contractual entitlements in relation to which close-out netting rights can be assessed.

English corporate insolvency law recognises rights accrued under general law prior to liquidation. A distinction is made between two types of rights, namely personal rights which are rights against particular persons as in the case of debts and enforceable only against them, and property or real rights which are rights in respect of assets and generally enforceable against all persons as in the case of security interests or title transfers. Security interests and other real rights created prior to the insolvency proceeding are unaffected by the winding-up and the creditor to whom these rights pertain may proceed to realise its security or assert other rights of property as if the company was not in liquidation. On the other hand, English law generally stays performance of personal claims so that the pursuit of personal rights against the company is converted into a right to prove for dividend in the liquidation to participate in any *pari passu* distribution.

A contractual provision intentionally aimed at the removal of an asset from the estate of an insolvent company upon winding-up is void as contrary to public policy. This is referred to as the anti-deprivation rule. Contrary to what has been stated above, this principle refers to the acquisition of rights where the appointment of a liquidator is itself a trigger for a contractual provision divesting the company of an asset it previously held. Such a provision would contravene the anti-deprivation rule since its effect is to intentionally remove from the reach of the general body of creditors an asset held by the company at the time of the liquidation. This rule is aimed at transactions which improperly reduce the value of the company's assets to the detriment of all unsecured creditors.

Perhaps the most debated principle in relation to the enforceability of close-out netting provisions is that unsecured creditors rank *pari passu* meaning that unsecured creditors are required to share alike in the common pool of assets and proceeds. Fletcher explains that the ultimate rationale for this principle is that insolvency proceedings are essentially of a collective nature and that no individual creditor should be enabled to gain an unfair advantage relative to the rest.[123] This contrasts with the view expressed by Ho who states that the *pari passu* principle is to be strictly distinguished from the principle of collectivity that underlies such provisions as the automatic stay. According to Ho, the automatic stay is meant to maintain the *status quo* and conserve the insolvent's estate but they are not meant to preserve any particular level of priority in the distribution regime.[124] Mokal is of a similar view, stating that the *pari passu* principle has rather limited effect in governing distributions of the insolvent's estate. According to Mokal, the *pari passu* principle has a specific purpose which is to ensure that creditors who hold similar claims under non-insolvency law are to be paid back the same proportion of their debt in their debtor's insolvency and is to be deemed as one manifestation of formal equality in insolvency law which, according to this author, is determined by pre-insolvency law.[125]

Impact of Close-out Netting

Close-out netting rights may be deemed compatible with most of the principles mentioned above. Close-out netting rights, although designated as personal rights, are given preferential treatment similar to security rights which may be asserted upon insolvency provided they arise from arrangements entered into prior to insolvency and there was no actual or constructive knowledge of the commencement of insolvency proceedings. Close-out netting rights may be considered as pre-insolvency entitlements and may be deemed to have accrued under general law through the recognition of the principle of contractual freedom prior to liquidation. Close-out netting rights are not considered to breach the anti-deprivation principle unless they are triggered solely by the commencement of insolvency proceedings so that if they apply equally inside and outside of an insolvency situation, as a general rule there is no intention to remove an asset from the estate of the insolvent debtor in breach of the anti-deprivation rule. This approach has been confirmed by the court in *Belmont Park Investments PTY Ltd v BNY Corporate*

123 FLETCHER (2017) 1-006. Fletcher criticises the traditional view that the *pari passu* principle is the foundation of the entire insolvency system. He states that the development of English insolvency law is one of 'almost perpetual accretion and revision and shifting socio-political influences' with lack of coordination in the development of English credit, security and insolvency laws with the consequence that the law is 'beset by anomalies and inconsistencies, particularly concerning the pari passu principle, which are in some instances squarely at odds with commercial and social realities […]'. *Ibid.* para 24-052.

124 HO (2006) 1731.

125 MOKAL (2005) 92.

Trustee Services Ltd[126] where it was held that taking into account 'commercial sense and absence of intention to evade insolvency laws', the courts will seek to give effect to the contractual terms and hence to party autonomy in the application of the anti-deprivation rule and 'there is a particularly strong case for autonomy in cases of complex financial instruments [..]'.[127]

From the debate on the *pari passu* principle made above, it appears that the impact of close-out netting may vary depending on the interpretation given to this principle. According to Firth, for the *pari passu* rule to be engaged there has to be an attempt to apply an asset of a debtor in a way which is inconsistent with the statutory order of distribution. Firth opines that the multilateral netting arrangements in *British Eagle* were held to be invalid following the winding-up of British Eagle because the majority considered British Eagle's rights against another airline, *i.e.* Air France, to have a claim for services rendered to Air France settled through the netting arrangement, to be an asset of that company which should have been paid to the liquidator and not to Air France. The position would have been different if, as the minority concluded, British Eagle only had a claim for the net sum against the clearing house at the end of each month. Firth explains that the effects of a close-out netting agreement is to create a type of flawed asset whose terms are such that the obligations of each of the parties are conditional on no event of default having occurred with respect to the other and the non-defaulting party's obligation to perform the transactions in the manner originally contemplated arises only if the transactions have not been closed out. Thereafter, performance is to take place by the payment of any close-out amount that is due from the non-defaulting party. Firth opines that there is therefore no application of an asset in a manner that is inconsistent with the insolvency legislation since the defaulting party merely has a limited right under the contract.[128]

Mokal adopts a different perspective and states that what cannot be contracted out of is not the *pari passu* principle but the whole collective system for the winding-up of insolvent estates. According to Mokal, it is forbidden for a creditor to leave his assigned ranking in the distribution scheme since this would frustrate the rules of the insolvency regime. Mokal opines that the netting arrangements in *British Eagle* may be considered as an attempt on the part of IATA to prevent its members from having to submit to the collective liquidation regime. However, the contracting out as such was not objectionable as Lord Cross implied that had the IATA arrangements created charges in favour of the IATA creditors with effects

126 [2012] 1 All E.R. 505.

127 *Ibid.* para 103. The ISDA English Law Opinion confirms that the type of provisions entered into under the ISDA master agreements are capable of satisfying the *Belmont* test as they are entered into in good faith and without the purpose of depriving the insolvent party of its assets. *Ibid.* 30. But see HUDSON [2018] para 17-91 *et seq.* for a criticism of the good faith argument in the *Belmont* case.

128 FIRTH (2013) para 5.060.

equivalent to the disputed netting scheme, those would have been effective against the liquidator if duly registered. So, according to Mokal, the objection was not granting certain creditors priority over others, but rather that advantages associated with recognising this 'novel way of acquiring immunity' was not sufficient to outweigh the costs of such a significant derogation from the collective regime.[129]

The preferred view adopted in this research is that the reference to the novel way of acquiring immunity made by Mokal perhaps best describes the application of close-out netting in relation to English insolvency law. Close-out netting is clearly inspired by the set-off concept which is a fundamental concept under English law and has found its place among the category of rights which are given preferential treatment in the scheme of distribution. Any set-off amount left unsettled is then regulated by the *pari passu* regime. One important distinction, however, is that whilst insolvency set-off operates in terms of mandatory law, close-out netting is based on party autonomy. Given the UK's obligation to implement the EU's FCD, the recognition of insolvency close-out netting provisions under English law has been significantly influenced by the provisions of the FCD. What is unique about the English concept of close-out netting is that protection is extended to close-out netting agreements forming part of a financial collateral arrangement concluded between corporate parties, whether or not they are also financial market participants. This widened scope may have been influenced by the general applicability of insolvency set-off under English law. Indeed, it is interesting to note the comment made by the English legislator in the FCAR consultation document that:

> '[the] overall approach in implementing the [EU] Directive is to extend the scope and usefulness of financial collateral arrangements as widely as possible having regard to general UK policy on insolvency. […] We have sought to promote further flexibility in the use of financial collateral arrangements in order to assist the competitive position of London as an international financial market.'[130]

It appears that an additional consideration for widening the scope of protection of financial collateral arrangements under the FCAR to corporates was therefore to promote London as a global financial market. This indicates that the legislator may opt to shape the law to fulfil State goals, even if the resultant law may not fall squarely within the rationale of insolvency law.

129 MOKAL (2005) 108.

130 HM TREASURY 2003 FCAR Consultation Document para 1.12. See also paras 2.2 to 2.4 of the FCAR consultation document.

4.4.2 Effect of State Goals on English Insolvency Law

The design of national insolvency law is invariably shaped by the goals set by the government of the day. In 1982, the Cork Report[131] laid the foundations for a new modern insolvency law. A White Paper[132] was issued in 1984, heralding the Insolvency Act. This Paper expanded on the Cork objectives by stressing the need to provide a statutory framework to encourage companies to manage the risks of their financial circumstances at an early stage, before prejudicing other creditor interests. The Insolvency Act of 1986 itself was based on two clear precepts, *i.e.* to establish formal legal procedures to business rescue and the orderly realisation and distribution of assets and to erect a regulatory framework to prevent commercial malpractice and abuse of the insolvency procedures. In 2002 there was a consolidation of the rescue culture brought about by the Enterprise Act and a new emphasis on managing insolvency risks proactively, with the intention to encourage more entrepreneurship.[133]

In more recent times, the legislator's attention has focused on the competitiveness of the financial markets. Finch notes that credit has become a commodity that is traded across the world in complex packages of debt so that relationships between lenders and borrowers have become more distant and less transparent.[134] This change has brought new risks which were unknown certainly at the time of the Cork Report and the Insolvency Act. Benjamin notes that the willingness of the financial markets to absorb new credit risk depends on the effectiveness of private and public law measures designed to ameliorate credit risk. At the same time any statutory pro-market measures could conflict with the distributive regime of insolvency law, including the *pari passu* principle.[135]

The tendency of English law has been to enhance the legal protection of the financial market. English law traditionally adopted a liberal attitude and placed heavy emphasis on creditors' rights, evidenced by the general principle on the respect for the pre-liquidation ordering of entitlements. Thus, the special treatment of the financial markets and related contracts is a significant exception to the application of general insolvency law principles.[136]

The question arises whether close-out netting arrangements effective under the party autonomy principle may be said to result from, or be in conformity with, these State goals. The FCAR was enacted in 2003, one year after the Enterprise Act. It cannot be said to favour the business rescue

131 Insolvency Law Review Committee 1982 Report.
132 DTI 1984 Cork Report.
133 FLETCHER (2017) 1-041.
134 FINCH & MILMAN (2017) 10.
135 BENJAMIN (2007) 39.
136 VAN ZWIETEN (2018) 350.

culture prevalent at the time. It is probably more appropriate to consider close-out netting arrangements in the light of protection given to market contracts in relation to recognised exchanges and clearing houses in Part VII of the Companies Act 1989 from the rules of insolvency law and the developments in the EU such as the adoption of the Finality Settlement Directive and the Financial Collateral Directive. These developments may be seen as an attempt to protect financial markets from systemic risk by exempting contracts such as close-out netting agreements from the ordinary effects of insolvency law. The problem with close-out netting arrangements under the FCAR is that their scope goes beyond aspects of systemic risk since even arrangements between corporates are protected with the result that the balancing between the interests of corporate netting creditors and other unsecured creditors may be disproportionate. It is suggested that this widened application under the FCAR may be best explained by the declaration made in the FCAR consultation document that this serves to enhance the competitiveness of the London financial market, given the importance of the netting mechanism to reduce credit and other risks.

Close-out netting may be considered a classic example of a concept which has been heavily shaped by the goals of the State. Thus, although the statutory recognition of party autonomy under English law occurred on account of the implementation of the EU's FCD, however the legislator extended its scope to corporates in order to implement the State goal of enhancing London's position in the global financial market. The recognition of party autonomy was both curtailed and safeguarded by the Banking Act in 2009. In this case the regulation was not, at least initially, triggered by EU law since the BRRD was adopted at a later stage. Some fine-tuning did take place in the law as a result of the implementation of the BRRD, which has served to further safeguard both the effectiveness of resolution measures as well as the rights of the solvent creditor benefiting from the netting arrangement. The law is therefore in the process of continuous re-evaluation of the scope which close-out netting is meant to achieve and in the process the balancing of interests affected by the close-out netting process and the party autonomy role in the enforcement of close-out netting provisions are also being re-assessed.

4.5 Preliminary Conclusions

Under English law, insolvency close-out netting provisions are currently regulated by three regimes, namely by the mandatory provisions of rule 14.25 of the Insolvency Rules 2016 in cases where the close-out netting provision fulfils the conditions of insolvency set-off, by the FCAR in the case of close-out netting provisions concluded by corporates as part of financial collateral arrangements and by the Banking Act in relation to all close-out netting provisions, whether governed by English or a foreign law, which have been entered into by a failing banking institution.

First Sub-question

Notwithstanding the standard set in the FCAR that close-out netting arrangements are to take effect in accordance with their terms, this standard is subject to conditions and exceptions. The first major exception relates to the mandatory operation of rule 14.25 of the Insolvency Rules 2016 which applies automatically in relation to executed contracts satisfying the requirements of this rule. Those which do not and executory contracts which fall within the scope of the FCAR, are protected insofar as there is no actual or constructive knowledge of the commencement of insolvency proceedings. Some doubt may be shed on this statement by regulations 12(4) and 14 of the FCAR which disapply only certain provisions on set-off in relation to close-out netting arrangements and may raise questions on the continued applicability of the other provisions. The preferred view expressed in this research is that these provisions should not be interpreted to imply that the other provisions on set-off are intended to apply to close-out netting arrangements benefiting from the party autonomy rule set in regulation 12 of the FCAR. Thus, in a preliminary reply to the first sub-question raised in the Introduction, the influence of insolvency set-off rules on the recognition granted to close-out netting depends on the scope of application of the arrangement of which the close-out netting provisions forms part. Generally speaking, those provisions falling within the scope of application of the FCAR are given recognition 'in accordance with their terms' and are not affected by insolvency set-off rules. On the other hand, close-out netting provisions not falling within the scope of the FCAR may need to be tailored on the mandatory rules of insolvency set-off in order not to be impugned in court as an attempt by the parties to contract out of the insolvency law.

Second Sub-question

English insolvency law generally enforces pre-insolvency contractual entitlements and recognises specified groups of preferential interests so that the preference given to close-out netting is aligned with English insolvency law principles. Hence, it appears that in relation to the second sub-question raised in the Introduction, English insolvency law would favour that close-out netting provisions take effect 'in accordance with their terms'. However, given the wide scope of application of the close-out regime under the FCAR, it is debated by English authors whether the preference given to netting creditors can be considered a proportionate departure from the *pari passu* principle. Considerations of credit risk, systemic risk and financial stability may have formed the basis of the EU's Financial Collateral Directive. However, the widened scope of the FCAR to cover also agreements between corporates takes the realm of the FCAR beyond justifications of systemic risk. It has been suggested that the reason for this approach may be the need to fulfil the State goal of enhancing the competitiveness of London as a global financial centre declared by the legislator in the FCAR consultation document. Given the central place occupied by close-out netting in financial agreements, in particular to reduce credit risk, it is understood that the legal soundness of close-out netting provisions will go a long way to promote London as a financial centre. Thus, whilst the nature of the preferences given to netting creditors may raise the debate on proportionality *vis-à-vis* the *pari passu* principle, the preferential treatment may be explained in the light of insolvency goals set by the state which favour the competitiveness of the market.

Third Sub-question

Close-out netting arrangements protected under the FCAR are made subject by regulation 12(5) to any restrictions that may be imposed by the Bank of England under the special resolution regime of the Banking Act 2009. Although this rule is termed very generically and may be widely interpreted to include any possible power that may be exercised by the Bank of England under the special resolution regime, the view taken in this research is that close-out netting arrangements, whether governed by the FCAR or not, are currently affected in three ways by the Banking Act 2009, namely in the exercise of termination rights, in property transfers and in the bail-in of net amounts. To interpret regulation 12(5) otherwise would imply that netting arrangements falling within the scope of the FCAR receive less protection than those which do not fall under the FCAR but which are still affected by the Banking Act. It has been seen that the Banking Act provisions do restrict contractual freedom insofar as concerns close-out netting arrangements to ensure the effective exercise of resolution measures, but this is being done with due consideration to the fact that the rights of netting creditors should not be unduly restricted and safeguards have been put in place. Although there is a significant loss of party autonomy, this may not always have negative repercussions. Thus, in the case of a transfer of contracts, the netting creditor may end up with a better counterparty whilst in the case of bail-in of net amounts the creditor should not be in a worse-off position than under normal insolvency proceedings. Whilst the analysis of the provisions of the Banking Act and the manner in which they affect close-out netting rights is important towards providing a reply to the third sub-question raised in the Introduction, the resolution regimes of the other two regimes need to be analysed prior to giving a preliminary reply to the question whether there is convergence in the type of restrictions imposed by the three selected resolution regimes. This analysis is therefore reserved for Part III.