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

Muscat, B.

**Author**: Muscat, B.
**Title**: Insolvency Close-out Netting: A comparative study of English, French and US laws in a global perspective
**Issue Date**: 2020-12-01

# Part III

# Comparative Analysis and the Influence of the Legal Systems

# 7 Comparative Analysis of the Close-out Netting Regimes of England, France and the US

## 7.1 Uniformity of the Close-out Netting Concept

Having focused on the theoretical aspects of close-out netting in Part I of this research and on the legal close-out netting regimes of England, France and the US as representative jurisdictions of the common, civil and eclectic legal systems in Part II, this chapter conducts a comparative law analysis of these three national regimes. The comparative analysis is intended to provide conclusive replies to the three sub-questions raised in the Introduction namely in relation to (i) the influence of national set-off rules on the development of close-out netting, (ii) the effect of national insolvency laws and state insolvency goals on the recognition of close-out netting provisions and (iii) the convergence or otherwise in the type of restrictions introduced by bank resolution regimes on the exercise of close-out netting rights. The conclusions of this chapter will then form the basis for analysing and replying in Chapter 8 to the main research question on the influence of the legal systems of England, France and the US in the extent of recognition given to close-out netting provisions.

The Giovannini Group noted in its November 2001 report on cross-border clearing and settlement arrangements in the EU that '[w]here netting has been introduced by […] legislation, its availability is normally limited to specific products, types of counterparty or forms of contractual documentation. This leads to the need for detailed analysis of the relevant features of a transaction before it can be safely assumed that netting will be available.'[1] Taking into consideration this concern expressed by the Giovannini Group and prior to considering the three sub-questions referred to above, the first issue to be analysed in this chapter is whether the concept of close-out netting is a uniform concept under the three regimes. In theory, the close-out netting mechanism consists of a three-step process which generally permits the non-defaulting party to terminate or accelerate the outstanding transactions, calculate the gains and losses on the basis of market values or replacement costs, and net amounts due to produce a single net balance payable by one party to the other. It is also typically concluded between financial institutions since close-out netting has the characteristics of a remedy to prevent loss resulting from financial contracts. An examination of the regulation of insolvency close-out netting under the selected regimes has, however, revealed that whilst the end result or economic outcome of

1 See Barrier 14, EUROPEAN COMMISSION 2001 Giovannini Group First Report.

the determination of a single amount is fairly constant, close-out netting may not be a coherent concept across the jurisdictions.

The comparative analysis of the concept of close-out netting will be divided in two parts, the first dealing with the constitutive elements of close-out netting and the second with the personal and material scope of application of the netting regimes. First, a comparative assessment is made whether and how the three-step process, comprising the rights of (i) close-out, (ii) valuation and (iii) netting, which make up the close-out netting mechanism have been incorporated in the laws of the selected regimes. In the second part dealing with the scope of application of national close-out netting regimes the main issue to be considered is whether, notwithstanding that the personal and material scope varies from one jurisdiction to the other, it can be said that at its core the close-out netting mechanism is restricted to the financial markets.

### 7.1.1 Constitutive Elements of Close-out Netting

The UNIDROIT Principles on the Operation of Close-out Netting Provisions provide in paragraph 19 that close-out netting 'is best described in functional terms, i.e., by reference to a result', this being the single net payment obligation. Accordingly, the UNIDROIT Principles consider the three steps constituting the close-out netting mechanism, namely termination, valuation and determination of a net amount, to be merely functional steps which describe what happens in practical terms but it is not necessary for all these steps to be present for the result, *i.e.* the single net payment obligation, to be achieved.[2] This approach implies that there are various ways in which close-out netting may be achieved and national laws do not necessarily have to follow a particular process to grant recognition to close-out netting provisions. It is the scope of this part to ascertain whether the three-step process of termination, valuation and determination of a net amount, which commands fairly wide acceptance in doctrine, all constitute elements of the close-out netting concept under the laws of the three selected jurisdictions.

*Constitutive Elements*

A reading of the literature used for this research gives the impression that whilst European authors' views appear to converge on the idea of a three-step process of the close-out netting mechanism, no such clear approach is taken by US authors. Admittedly, the European approach could have been influenced by the EU's FCD which is based on the three-step process. Notwithstanding this possible influence, the implementation of the English and French close-out netting regimes is sufficiently diverse to merit a comparative exercise between these two regimes for the purposes of the

2 See paragraphs 32 & 33, UNIDROIT 2013 Close-out Netting Principles.

main question. It is expected that the major difference will be the comparison with the US safe harbours which are expressed in a more unique style and language.

Under English law the primary source for determining the elements of the concept of close-out netting is arguably the definition of 'close-out netting provision' provided by regulation 3(1) of the FCAR which for the most part reproduces the definition of the same term in Article 2(1)(n) of the FCD. In terms of the FCAR definition, a close-out netting provision is activated by the occurrence of an enforcement event and leads to (i) the acceleration or termination of outstanding obligations, (ii) the establishment of amounts representing each original obligation's estimated current value or replacement cost and (iii) the netting or setting off of the amounts due so that a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party. English law doctrine is virtually consistent in identifying the aforementioned three steps in the close-out netting process.[3] On the other hand, the definition of close-out netting arrangements in section 48(1)(d) of the Banking Act 2009 which refers to the calculation of the actual or theoretical debts for the purpose of enabling them to be set off against each other or be converted into a net debt, places more emphasis on the elements of calculation and determination of a net amount. Since this definition is meant to serve the specific purposes of resolution measures under the Banking Act where it is considered important that contracts are not terminated to allow the resolution authority to adopt any resolution measures deemed necessary, it may not be suitable for the purposes of analysing comprehensively the constitutive factors of close-out netting under English law. Still it is noteworthy that the element of valuation is given prominence in this definition, thereby confirming that it is considered by the English legislator as one of the constitutive elements of close-out netting.

Whilst the elements of close-out netting under English law are regulated in the definitions of the FCAR, under French law these are regulated in the main text of article L.211-36-1 of the Financial Code. This article is striking by the lack of reference to the term close-out netting as a notion as it refers instead to its constitutive elements. Thus, paragraph I of this article, which sets the main rule granting recognition to close-out netting provisions, refers to only two aspects of close-out netting namely to the termination element and to the possibility of setting off the outstanding obligations. In fact, this is the idea imparted by Bonneau *et al.* who appear to consider two steps in the close-out netting process, namely close-out consisting of the early termination of the contract and the netting which permits the set-off of reciprocal debts, adding that these are evaluated in accordance with the terms of the contact. Thus, according to these authors, the valuation aspect is embedded

3 For instance, see YEOWART *et al.* (2016) 602; ANNETTS & MURRAY (2012) 269.

in the other two steps.[4] In paragraph II, however, reference is made twice to the enforceability of the contractual modalities of termination, valuation and set-off, making it clear that in the mind of the French legislator these are the three constitutive elements of the close-out netting concept. The reference in paragraph II to *all* contractual modalities of termination, valuation and set-off stipulated in agreements and master agreements implies that the various modalities of termination may also include acceleration of obligations and the reference to the various modalities of set-off also implies other forms of determining a close-out amount, such as by novation netting.[5]

US law generally lacks a unified concept of close-out netting, so that close-out and netting are considered as two separate rights which may be related to a single contract. It may therefore appear that under US law there is conceptually a reversal of steps in the sense that there should first be a contract in place for close-out and netting to be considered as unified under that contract. The approach taken by the US legislator under the safe harbours of the Bankruptcy Code is to protect contractual rights generally. Ultimately, however, the contractual rights referred to in for instance section 560 of the Bankruptcy Code are in fact the type of rights exercised under a close-out netting provision, namely termination and its variants liquidation and acceleration on the one hand, and, on the other, the offset or netting of 'termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements.' This provision combines a number of factors which in the end may signify that the concept of close-out netting is not much different from that envisaged in the other two jurisdictions. The most prominently featured element is that of termination, liquidation and acceleration which is an expression of all the modalities of cancellation of a contract. Second, the reference to termination values or payment amounts is an acknowledgement that a valuation of outstanding obligations should take place to obtain a close-out amount. Finally, the modalities of offset or netting of termination amounts are specifically mentioned in relation to the termination, liquidation or acceleration of the obligations thus creating the necessary contractual link between these three aspects of close-out netting. However, unlike the other two jurisdictions which have more clearly specified the three constitutive elements in their respective laws, it is only by way of interpretation that the valuation aspect can be assumed under US law. This is also the case with section 403 of FDICIA which only mentions the termination aspect, including liquidation and acceleration, and the netting aspect, and then adds the wording 'in accordance with, and subject to the conditions of, the terms of any applicable netting contract'. It is again a matter of interpretation that leads to the assumption that any valuation of outstanding obligations is covered by the terms 'subject to the conditions'

4 See BONNEAU *et al.* (2017) para. 933.
5 See in this respect GAUDEMET (2010) para. 464.

of the netting contract, given that in the standard master agreements such a condition would constitute an important aspect of the close-out netting mechanism. Thus, valuation may be considered either as an essential or, at least, as an ancillary aspect of another constitutive element, *i.e.* of close-out.

*Ancillary Issues*

Although not considered as constitutive elements, other ancillary issues are analysed below as they help set the confines of operation of close-out netting on the basis of the three-step process and clarify further the recognition granted to close-out netting provisions under the three selected regimes. These issues relate to (i) the requirement for close-out netting to form part of a financial collateral arrangement, (ii) the role given to set-off in the determination of a close-out amount and (iii) whether the single agreement concept is necessary to ensure connexity between the obligations which are subjected to netting.

*(i) Part of a Financial Collateral Arrangement*

Under the FCAR, the English legislator grants protection to a close-out netting provision if it forms part of a financial collateral arrangement. This stems from the definition of a 'close-out netting provision' in regulation 3(1) of the FCAR which is limited to 'a term of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part.' As already noted, this state of affairs may be a consequence of the fact that the FCAR implement the EU's FCD which applies in the context of financial collateral arrangements. This, and the conviction of English authors that close-out netting will be upheld independently of the FCAR protection provided it fulfils the requirements of insolvency set-off, may have restricted the protection granted by law to close-out netting provisions.

On the other hand, French law has implemented the FCD by separating the part on the protection of close-out netting from that on harmonisation of the rules of financial collateral arrangements. The former is regulated under article L.211-36-1 and the latter under article L.211-38 of the Financial Code. In this way the French legislator has avoided the situation whereby the protection of close-out netting provisions is restricted to those provisions forming part of a financial collateral arrangement. This situation does not preclude that any collateral provided for the purposes of setting off with amounts due is taken into account for the purposes of a close-out netting provision.[6]

6 See article L.211-38, I and IV of the Financial Code.

Similarly, under US law a close-out netting provision does not have to form part of a financial collateral arrangement in order to receive protection under the safe harbours. It is interesting, however, to note the approach taken by some US authors in relation to the importance of credit enhancement for a close-out netting provision. Thus, Bliss and Kaufman make the generic statement that 'closeout and netting perform different economic functions, and both are in practice tied to collateral.'[7] Janger *et al.* go a step further and state that close-out netting constitutes three steps, namely termination, set-off and sale of collateral.[8] These comments may reflect a special position which credit enhancement has under the US safe harbours. However, it is doubtful whether the sale of collateral must be considered as an essential constitutive element of close-out netting given that under US law it is not necessary that close-out netting forms part of a collateral arrangement in order to receive the safe harbour protection. The emphasis being made on the sale of collateral may reflect the fact that credit enhancement is embedded in the various definitions of the types of agreement protected under the safe harbours. This is, for instance, the case in relation to section 560 of the Bankruptcy Code dealing with swap agreements. However, the reference to credit enhancement is included in such definitions in the sense that any credit enhancement may be taken into account for the purpose of determining a net amount, and not in the sense that the existence of credit enhancement is necessary for close-out netting to receive protection under the safe harbour.

*(ii) Role Given to Set-off*

All three regimes refer to the modality of set-off to achieve a single payment amount. Thus, the English FCAR definition of 'close-out netting provision' in its regulation 3(1) refers to both the netting and set-off modalities for achieving a single close-out amount. Set-off is therefore one, of other, modalities by which a single net amount may be determined under the FCAR. The reference to set-off in this context is to contractual set-off, rather than insolvency set-off.[9]

Set-off is stated to be the main modality to determine a close-out amount under article L.211-36-1 of the French Financial Code, but article L.211-36-1, II of the Financial Code itself gives recognition to *all* contractual modalities of termination, evaluation and set-off so that a wider meaning to set-off should be given in this context.[10] The situation may have been different under the old law where the former article 1290 of the Civil Code

7 BLISS & KAUFMAN (2006) 57.

8 JANGER *et al.* (2014) 3.

9 See ANNETTS & MURRAY (2012) 277; YEOWART *et al.* (2016) 448.

10 This wider interpretation of set-off conforms with the term given by French jurists to close-out netting, namely '*résiliation-compensation*' and in keeping with the notion that the French legislator used existing French concepts to construe the close-out netting concept.

applied automatically in cases where reciprocal debts under terminated contracts are liquid, fungible and due.[11] This is contrary to the view under English law where the established view is that the set-off modality referred to under close-out netting is that of contractual set-off. Following the recent changes to the French Civil Code where set-off is no longer of a mandatory nature, it is probably the case that both laws converge on this point.

Section 560 of the US Bankruptcy Code refers to both offset and netting for the purpose of determining a single payment amount when related to the termination, liquidation or acceleration of a financial contract. It has been seen that offset is considered separate from ordinary set-off under US law and is a type of contractual set-off.[12] On the other hand, there is a remarked absence of a reference to offset under both the definition of 'netting contract' in section 402 of FDICIA and the general rule on bilateral netting in section 403 of FDICIA, which could be either an indication that offset no longer has a role to play in close-out netting or, arguably the more correct view is that FDICIA uses more modern terminology in conformity with the idea that there are various modalities by which a single net amount can be achieved, which may include offset.

*(iii) Single Agreement Concept*

A question arises whether it is necessary under the three selected regimes for obligations affected by a close-out netting agreement to be linked to a single financial agreement to ensure some form of connexity between them.

According to the definition of 'close-out netting provision' in regulation 3(1) of the FCAR, the close-out netting provision must form part of a financial collateral arrangement. It is not clear whether this constitutes a requirement to incorporate the single agreement concept to ensure recognition of a close-out netting provision, which serves to tie all obligations subject to the close-out netting provision together so as to avoid any cherry-picking under national law, or whether the reference is simply a coincidental implementation of the FCD and should not be given any ulterior motive. Although there is not sufficient clarity on the terminology used to state that a single agreement is postulated as a requirement for the protection of any close-out netting process, it is nonetheless a pre-requisite for protection of close-out netting provisions under the FCAR.

In terms of article L.211-36-1, II of the French Financial Code the modalities of termination, valuation and set-off *may* be governed by an agreement or master agreement ('*Ces modalités peuvent être notamment prévue par des conventions ou conventions-cadres.*'), thereby indicating that it is not a necessity that a close-out netting provision is associated with a contract

11 According to Gaudemet, once obligations are terminated and given a monetary value under a close-out netting provision, it is possible that set-off automatically applies under the old law. See GAUDEMET (2010) para. 470.

12 See Chapter 6.2.

and therefore with the single agreement concept. Although it appears to be discretionary whether the three constitutive elements of close-out netting should derive from a contract, according to doctrine a close-out netting provision should be linked to either the same contract or to various contracts through global netting.[13]

The situation is slightly different under US law where the understanding of US authors is that close-out and netting are separate rights which become related when incorporated in the same contract. The safe harbours protect contractual rights and do not specifically protect a close-out netting provision which renders it difficult to examine the single agreement concept. An indication is given by section 560 of the Bankruptcy Code that close-out and netting are to be tied to a contract when it refers to 'offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of *one or more swap agreements*.' Strictly speaking, this is not a reference to the single agreement concept but constitutes a way of linking the separate contractual rights of close-out and netting to the same contract or contracts. Similar to the other safe harbours under the Bankruptcy Code the second part of section 560 defines the term 'contractual right' to include also rights arising from industry association rules or bylaws, from common law and law merchant, among others, 'whether or not evidenced in writing', which implies that the contractual rights of close-out and of netting will be protected not only if they are linked to a contract, but also if they are linked through other means such as industry bylaws or market practice. Section 403 of FDICIA, on the other hand, provides that:

> '[T]he covered contractual payment obligations and the covered contractual payment entitlements […] shall be terminated, liquidated, accelerated, and netted in accordance with, and subject to the conditions of, the terms of any applicable netting contract.'

Rather than a requirement for the existence of a single agreement, this constitutes a reference to the standard 'in accordance with the terms' of the netting agreement. Ultimately, US law does not directly impose the single agreement concept to link the obligations under the close-out netting provisions especially since the contractual rights being protected may emanate either from contractual or non-contractual sources.

In sum, it can be stated that it is the same close-out netting concept, in its various contractual modalities, that is being protected by the three selected jurisdictions. It is therefore arguable that close-out netting is not solely a functional process with an economic outcome, *i.e.* the determination of a single net payment sum, but under the law of the three selected jurisdictions it is a concept constituted of the three elements of (i) termination, (ii) valuation and (iii) determination of a net amount. Only in the case of

13 See JURISCLASSEUR (2013) Fasc. 2050, para. 84-86.

English law is there a requirement that the close-out netting forms part of a financial collateral arrangement, as otherwise the other two jurisdictions only mention the requirement (in non-mandatory terms) that the obligations emanate from an agreement or master agreement. However, the terminology used does not go so far as to require the single agreement concept which is common to standard master agreements such as the ISDA master agreement. Hence, this remains an issue determined by market practice and does not appear to be enshrined in the law of the selected jurisdictions. Finally, it has been seen that in all three regimes, set-off is a modality to determine a close-out amount, with the common understanding being that the set-off modality is that of contractual set-off, rather than insolvency set-off which would typically require the fulfilment of certain conditions.

### 7.1.2 Scope of Application

As a general rule, the delimitation of the scope of application of a national netting regime should reflect the type of risks that the legislator is seeking to avert, in particular since the enforceability of close-out netting provisions ultimately entails important derogations from the application of mandatory insolvency law principles, at times to the detriment of other existing creditors. It would therefore seem logical that national laws limit the application of this risk mitigation mechanism to certain financial parties operating in the financial markets, for instance the derivatives market where the fluctuating values of financial instruments and the typical hedging of investment portfolios renders these financial instruments particularly vulnerable to the consequences of insolvencies.[14]

ISDA, as lead proponent on the promulgation of national netting laws, has advocated that the identification of relevant national policy is of utmost importance for the adoption of netting legislation, in particular since netting legislation involves a regime which derogates from the normally applicable insolvency rules, so that these may only be justified in relation to certain eligible parties and in certain specific contexts. ISDA asserts, however, that whilst it may be appropriate for the legislator to limit certain types of financial activity, it may not 'make sense to limit the effectiveness of close-out netting by reference to types of market participants.'[15] This assertion is based on the assumption that systemic risk reduction should benefit all market participants without providing much economic justification for this assumption. On the other hand, when discussing the importance of the enforceability of bilateral close-out netting, Recital (14) of the EU Financial

14 For this reason, loans and deposits are typically excluded from the scope of application since they are not subject to rapid changes in value or the volatility of markets, albeit deposits may receive special protection under bank resolution regimes. See UNIDROIT 2013 Close-out Netting Principles, para. 90. These Principles, however, also list instances where loans and deposits may be taken into account. *Ibid.*

15 ISDA 2006 Guide for Legislators, 3 & 4.

Collateral Directive provides that '[s]ound risk management practices commonly used in the financial market should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis […].' The emphasis of the FCD is therefore that, even though there may be limitations on the types of financial market counterparties receiving protection, it is important that *all* financial obligations entered into between specified counterparties are protected. Although at opposing sides of the spectrum, both the ISDA declaration and the FCD indicate the necessity of maintaining a significant link with the financial markets, either through the personal or the material scope of the close-out netting law. It will be examined in this part whether any of these two opposing stances is reflected in the selected regimes or whether a totally different approach has been implemented which could even result in severing the link with the financial markets.

The scope of application is probably the issue which creates most discrepancies between national laws since arguably no netting law is exactly the same in relation to its scope of application. Although the various discrepancies will not be analysed in detail, the focus of this part will be to ascertain whether a strong link has been maintained with the financial markets or whether a wider scope has been made applicable. In the former case, it may be easier to justify the derogations granted to close-out netting on the basis of state insolvency goals related to systemic risk considerations. A wider scope may entail the consideration of other grounds such as competitiveness or possibly the influence of the wide application of set-off laws which may have perpetrated itself upon close-out netting regulation. These considerations related to the scope of application will be analysed in part 7.3.1 of this chapter in order to understand the rationale for the scope of application of close-out netting regulation by reference to the state insolvency goals.

The protection of close-out netting under the English FCAR is closely modelled on the FCD for its material scope which widely refers to 'relevant financial obligations' covered by a title transfer or a security type of financial collateral arrangement in relation to cash, financial instruments including shares, bonds and other securities giving rights to acquire shares or bonds, or credit claims. The material scope of the FCAR therefore conforms with the stance recommended by Recital (14) of the FCD considered above. However, the personal scope of the FCAR is significantly wider than both the FCD and ISDA stances and covers also close-out netting provisions to which *both* parties are corporates or 'non-natural persons' in terms of regulation 3 of the FCAR. The ISDA stance to cover any type of market participant is deemed to be a reference to a *financial* market participant. Under English law, however, the parties can be any type of corporate who have entered into financial collateral arrangements in relation to 'relevant financial obligations', also widely defined. In terms of the FCAR consultation document this extended personal scope was considered to be consistent with the 'overall policy objectives' of English law, that is to reduce systemic risk and to increase the efficiency of the markets, and that it furthermore simplified implementation by avoiding the need to introduce 'elaborate definitions'.[16] Gullifer does not agree with the declaration made by the court *obiter dictum* in the *Cukurova* case that the wider the scope of the FCAR, the better the protection against systemic risk,[17] since it implies that the FCAR could cover straightforward business financing arrangements, such as a loan made to a company secured by a charge over its bank account, which she argues should be subject to the normal insolvency regime.[18] The wide scope of application may also stem from the general idea expressed in the FCAR consultation document in relation to the implementation of Article 7(2) of the FCD where it is stated that there were no restrictions to the implementation of close-out netting provisions under English law[19] which is deemed to be a reference to the wide applicability of insolvency set-off law.

In relation to the French close-out netting regime, article L.211-36-1 of the Financial Code permits the close-out netting of financial instruments listed in article L.211-1 of the Financial Code relating to financial securities and financial contracts, and covers also options, futures, swaps and all forward contracts listed in article L.211-36, II of the Financial Code. Eligible persons include regulated institutions and public bodies as provided in the EU's FCD. However, it has been seen that article L.211-36-1 of the Financial Code reflects a partial opt-out permitted by Article 1(3) of the FCD. Thus, if one of the parties to the close-out netting arrangement is not an eligible person, then the arrangement must regard financial obligations resulting from the aforesaid financial instruments. In this case, the non-eligible person could be any corporate or an individual. French law therefore adopts a restricted material scope where one of the parties is a non-eligible person but goes beyond the FCD and ISDA stances in relation to the personal scope, in particular by extending protection to arrangements of individuals contracting with an eligible person, which position would be difficult to justify on systemic grounds and could be deemed to conflict with Article 1(2)(e) of the FCD excluding natural persons from its personal scope.[20] On the other hand, if both parties are eligible persons, then the wider FCD material scope becomes applicable which is not limited to transactions involving financial instruments but covers also financial obligations

---

16 HM TREASURY 2003 FCAR Consultation Document, para. 2.3.

17 *R (on the application of Cukurova Finance International Ltd) v HM Treasury* [2008] EWHC2567 (Admin) at [96].

18 GULLIFER (2017) 274.

19 HM TREASURY 2003 FCAR Consultation Document, para 4.6.

20 In *Private Equity Insurance Group' SIA v Swedbank' SA* (Case C-156/15) delivered on 10 November 2016 a preliminary reference was made to the European Court of Justice by the Latvian Supreme Court on whether the implementation of the FCD in national law could include physical persons in its personal scope. Unfortunately, the European Court did not give its ruling on this question since it deemed the question to be hypothetical and declared it inadmissible.

resulting from all contracts related to payment of cash or title transfer. However, it is important to note that the law still refers to financial obligations, as opposed to commercial ones, so that there are excluded commercial operations resulting from the sale of goods or provision of services which are not financial operations.[21] The more restricted material scope in the case of arrangements concluded with non-eligible persons is in keeping with the idea expressed in Chapter 5.2.2 that the close-out netting mechanism is considered by a number of French jurists as a form of indemnification which is typically available in the financial markets to cover for losses that may be suffered by financial market players on account of the default of their counterparties.[22] Unlike English law which protects financial arrangements also concluded between corporates, the close-out netting regime under French law does not apply at all if none of the parties to a financial agreement is an eligible person so that whilst English law maintains a link with the financial markets through its material scope, French law does so through its personal scope.

The US safe harbours are based on a three-pillar structure since they seek to protect the contractual rights of stipulated parties to particular financial contracts[23] from the application of the Bankruptcy Code. Contractual rights include the ability to terminate and set off or net payment or delivery obligations. In 2005 BAPCPA added the notion of 'financial participant'[24] to the already long list of protected parties, with the result, according to Morrison and Riegel, that the law now exempts 'sophisticated' financial participants from the reach of the automatic stay and other mandatory principles of insolvency law.[25] The fact that section 560 of the Bankruptcy Code, which grants protection to contractual rights of swap agreements, has been widely construed to cover effectively all derivative contracts and any party thereto, not only financial parties, may have brought about the elimination of the three-pillar construction on which the safe harbours were traditionally built. Of wider scope are the provisions of FDICIA, notably sections 402 which in the definition of 'netting contract' refers to the more general term of 'financial institutions' and the material scope is stated to be the netting of 'present or future payment obligations or payment entitlements'.[26] However, as pointed out by Bliss, the Federal Reserve's criteria stipulated in Regulation EE for determining whether a financial institution qualifies under the FDICIA definition is that the 'firm must be a trader or

21 JURISCLASSEUR (2013) Fasc. 2050, paras 74 & 77.
22 See GAUDEMET (2010) para. 468.
23 11 U.S.C. §§ 362(b)(6), 555, 556, 559, 560 & 561. Covered contracts and protected parties have been defined in Chapter 6.3.
24 11 U.S.C. § 101(22A). It has been seen in Chapter 6.3 that the size requirements for a financial participant are $1 billion of gross national principal outstanding or $100 million of gross marked-to-market value of outstanding positions.
25 MORRISON & RIEGEL (2015) 650.
26 12 U.S.C. § 4402(14)(A)(i).

dealer, rather than an end user, and meet a minimum size requirement.'[27] In relation to the material scope, Morrison and Riegel state that these extensions of protection contracts may have shifted the focus of the Bankruptcy Code to form over substance and it may be now more difficult for judges to draw a boundary line between financial contracts and ordinary loans.[28] Since the material scope has been widened to this extent, must the link to the financial markets then be established on the ground of the parties to the agreements? Bliss appears to think so when he states that the US safe harbours provide no protection in relation to contracts entered into between financial institutions and non-financial institutions.[29] However, it may be counterargued, at least theoretically, that certain important definitions under section 101 of the Bankruptcy Code, such as that of swap participant and financial participant, are so wide as to cover any party, whether financial or not, although the minimum size requirement should be met to qualify as a financial participant. Thus, although in form the idea is that the safe harbours are only operative in respect of stipulated financial contracts entered into by financial parties, in substance the definitions are so wide and flexible in their interpretation that arguably the link with the financial markets is rather tenuous and the stance taken goes beyond those proposed by ISDA and the FCD.

This comparative analysis has confirmed the global tendency for the existence of significant discrepancies in the scope of application of national close-out netting regimes. The discrepancies exist even in relation to the English and French regimes which are meant to implement the FCD and are therefore based on a common source. Indeed, whilst English law has been faithful in implementing the material scope of the FCD, it goes beyond its personal scope by protecting arrangements concluded between two corporates so that a link with the financial markets is kept through its material scope only. French law, on the other hand, applies a wider material regime if the arrangement is concluded by two eligible persons and a narrower material regime if one of the parties is not an eligible person, such as a corporate or an individual, so that it depends on the situation whether the stronger link is maintained through the material or the personal scope. Also, English law requires that the close-out netting provision should form part of a financial collateral arrangement and French law does not. As a matter of form, US law appears to maintain a link with the financial market through both the material and personal scope but in substance the flexibility and wide remit of the definitions of eligible parties and contracts may have significantly widened both the personal and material scope of application beyond the realm of the financial markets. As a result of these discrepancies, the comparative analysis does not give an indication whether the link to

27 BLISS (2003) 55. See Regulation EE, 12 C.F.R. § 231.

28 Morrison and Riegel cite examples how an ordinary loan may be replicated by a combination of financial contracts. MORRISON & RIEGEL (2015) 657.

29 BLISS (2003) 55.

the financial markets is most likely to be in relation to either the personal or material scope of application. One common trait is that all three jurisdictions have demonstrated a tendency to widen the scope of application of their close-out netting regimes, albeit in varying ways. It will be considered in part 7.3 of this chapter whether this widened scope of application is intended to attain a particular target chosen by the national legislator in pursuit of a declared state insolvency goal.

## 7.2 Relationship with Set-off

It was stated at the beginning of this research that the netting technique, in its various forms, is a relatively novel mechanism based on party autonomy which combines pre-existing legal concepts and adapts them to financial market practices.[30] In this respect, the UNIDROIT Principles acknowledge that '[b]roadly speaking, close-out netting is often understood as resembling the classical concept of set-off applied upon default or insolvency of one of the parties.'[31] Both concepts of set-off and netting achieve the same economic result, namely the payment of a single amount following the aggregation of values of two or more obligations owing reciprocally between the parties, but the UNIDROIT Principles confirm that the close-out netting concept 'encompasses additional elements, providing, for instance, for the netting of obligations not yet payable', which may be an obstacle under ordinary set-off rules.[32] It is the scope of this part to compare the constitutive elements of the concepts of set-off and close-out netting with a view to establishing whether set-off law has influenced the recognition of close-out netting under the laws of the three selected jurisdictions. The analysis of this part will serve to provide replies in the Preliminary Conclusions to the first sub-question of the Introduction.

### 7.2.1 Scope for Contractual Enhancement

All three selected regimes refer to set-off in their netting laws. This is done in the context of considering set-off as a modality for the determination of a single amount once a contract has been terminated and outstanding obligations evaluated, which aspect has been termed by the UNIDROIT Principles as the 'set-off of all due and payable obligations in the classical sense.'[33] However, different from the 'classic' set-off, the reference in these three regimes is to the contractual modality of set-off which may be selected by the parties as one type of modality for determining a close-out amount.

30 See Chapter 1.2.
31 UNIDROIT 2013 Close-out Netting Principles, para 3.
32 *Ibid.*
33 *Ibid.* para 36.

Dalhuisen notes that set-off is commonly considered as a means of extinguishing a debt and that on account of its exposure reduction characteristics it may also be considered as a risk management tool, capable of acquiring other features. He states that the enhancement of set-off would usually occur by contract and could result in the elimination of certain of its basic requirements, giving rise to other structures that become separate from set-off in the traditional sense. Dalhuisen draws an interesting distinction between those jurisdictions where set-off is mandatory and those were it is subject to notification or invocation, stating that contractual variations on the set-off principle so introduced are likely to be more favourably considered in countries where the set-off is subject to notification and considered a legal act which may imply the parties having a say in the set-off method, different therefore in principle from countries where the set-off is always automatic, even outside bankruptcy.[34] Following the enactment of specific netting legislation in the three selected jurisdictions, it can be safely stated that close-out netting is, to varying degrees, protected across all three jurisdictions. The link with set-off is also present in all three jurisdictions and it will be analysed in this part whether any traces of the distinction made by Dalhuisen between mandatory and voluntary set-off regimes can be detected in the three selected jurisdictions.

*English Law*

English law operates a mandatory, self-executing insolvency set-off regime whose rules cannot be contracted out of as a matter of public policy. Typical of other traditional set-off regimes, insolvency set-off under English law has a wide scope of application, covering practically all types of obligations, except those arising from tort or damages, and any type of counterparty, including corporates and individuals. The self-executing nature of insolvency close-out netting under English law implies that once the conditions for the application of insolvency set-off have been met, these apply notwithstanding any close-out netting provision applicable to those obligations. The question therefore arises whether insolvency close-out netting based on regulation 12(1) of the FCAR constitutes a sufficiently clear stand-alone concept.

Although, as seen in more detail in Chapter 4.2.1, a number of requirements should be met for insolvency set-off to become applicable, insolvency set-off applies with sufficient flexibility as to share a number of features with close-out netting, which in other jurisdictions may not be readily the case. From the point of view of the fulfilment of requirements, for both insolvency set-off and close-out netting the dealings must be strictly mutual[35] and neither will apply if a party has notice of a specified insol-

34 DALHUISEN (2019) 387.

35 It has been seen, however, in Chapter 4.2.1 that English law recognises the assignment of claims and cross-guarantees to fulfil the mutuality requirement for set-off purposes.

vency event occurring in relation to the other and in the case of close-out netting this is extended to constructive knowledge. It is permitted for both concepts that sums due in the future or payable on a contingency are taken into account and valued, though this is not without some uncertainty for insolvency set-off as seen in Chapter 4.2.1. On the other hand, the more significant distinguishing features of close-out netting are the ability to convert non-monetary obligations such as obligations to deliver or transfer securities into monetary ones, the avoidance of uncertainty relating to the valuation of future and contingent debts by an insolvency practitioner and the ability to terminate or accelerate obligations in relation to executory contracts. It may seem at first glance that there is not much contractual enhancement pertaining to close-out netting given the flexibility with which insolvency set-off operates.

Prior to the enactment of the FCAR in 2003, insolvency close-out netting was governed by the provisions of insolvency set-off as then regulated by the Insolvency Regulations 1986. This approach was confirmed by the 1993 Statement of Law on 'Netting of Counterparty Exposure' issued by the UK Financial Law Panel considered in Chapter 4.2.2. It is to be noted, that in the *British Eagle* case it was stated *obiter* that netting arrangements not deemed to conform with insolvency rules could be rejected as an attempt to 'contract out' of mandatory provisions of law. Indeed, prior to the enactment of the FCAR in 2003, the justification of these netting arrangements involved lengthy argumentation devolving around the applicability of insolvency law axioms,[36] and this notwithstanding the 1993 Statement confirming that close-out netting worked under English law. The FCAR brought a significant amount of certainty in relation to the contractual enhancement features of close-out netting, though it is still the case that close-out netting continues to be overshadowed by the mandatory provisions of insolvency set-off.

In relation to English doctrine, it is invariably the case that literature treats insolvency set-off and close-out netting together. According to Yeowart *et al.*, this close relationship between the two concepts:

> 'is not a coincidence because close-out netting provisions in agreements governed by English law have been modelled upon principles that underpin rules 2.85 and 4.90, IR 86, and their predecessors, and the definition in the FCARs reflects this. This was necessarily the case because insolvency set-off under English law is mandatory and it is not possible to contract out of it.'[37]

This close association may have led to the wide personal scope of the English close-out netting regime to include arrangements between two corporates, as already indicated in the first part of this chapter. It may have

36 See in this respect DERHAM (1991) 539.
37 YEOWART *et al.* (2016) 224.

also led to the specific disapplication or modification of certain provisions on insolvency set-off under regulations 12(4) and 14 of the FCAR, even though the general interpretation is that also other insolvency set-off provisions do not apply.[38]

The view has been discussed in Chapter 4.3 that insolvency set-off rules may replace close-out netting in circumstances where the conditions of regulation 12(2) of the FCAR have not been fulfilled, such as where there is constructive knowledge of an impending insolvency.[39] This view, however, is not convincing on account of the separate requirements of the two notions. Thus, it is not possible under insolvency set-off rules to terminate outstanding obligations in an executory contract. This is only possible in the case of close-out netting. Therefore, in the eventuality that the solvent party is deemed to be aware of the pending insolvency, then this situation should lead to the disapplication of the close-out netting provision rather than to its replacement by insolvency set-off. Indeed, the only possibility for insolvency set-off to replace close-out netting is when its conditions of application materialise before the termination phase of a close-out netting provision since the ability to terminate is only possible in close-out netting.

There are therefore sufficient technical aspects, borne out of the notion of contractual enhancements, which have shaped the concept of close-out netting as a stand-alone concept and the link with set-off should, also technically speaking, be only of one contractual modality amongst others to determine the close-out amount once the termination and evaluation phases of close-out netting have been concluded. However, on account of the mandatory nature of insolvency set-off, it has to be ensured that a close-out netting provision is drafted in a resilient manner so that insolvency set-off does not replace the contractual terms.[40] This should be simpler to achieve in the case of executory contracts which will require the termination or acceleration of the outstanding obligations, since this feature is only permitted under the party autonomy aspects of close-out netting as recognised by the FCAR.

*French Law*

Since its incorporation into the Napoleonic Code, France operated a mandatory set-off regime until this was converted to a voluntary one following the 2016 amendments. The automaticity of the extinguishment of two debts was intended for set-off to operate as a means of payment. Notwithstanding the reversal of the automaticity under articles 1347 and 1348 of the French

38 See Chapter 4.3.

39 For instance, this is one of the interpretations given by Ho and analysed in Chapter 4.3. However, Ho's preferred interpretation is that in the circumstances where the requirements of insolvency set-off are fulfilled, they will always take precedence over the recognition of close-out netting. HO (2012) 351.

40 See GULLIFER (2017) 386.

Civil Code, it is still dealt with under the heading of extinguishment of obligations and hence *prima facie* is still considered as a means of payment. This reversal was possible, in part, due to the fact that set-off is not considered to be a public policy rule under French law and could be waived.[41] In addition, the extinctive effect is deemed to take place when all conditions of legal set-off have been met, and not from the date when it is invoked.[42] This may serve to reconfirm its characteristic as a means of payment. Contrary to English law, French law does not have a concept of insolvency set-off, but recognises three types of set-off, namely legal, judicial and contractual, which may apply both in and outside of insolvency, subject to provisions of law.

Arguably, since there is no notion of insolvency set-off under French law and parties could waive their right of set-off, close-out netting could develop as a separate branch of law which borrowed from the set-off concept but was not overshadowed by it. The need was felt by the French legislator to grant protection to close-out netting provisions more than a decade before the obligation to transpose the FCD arose. The special features of close-out netting which are particularly suited as a loss indemnification mechanism for the financial markets[43] were therefore long appreciated and constantly finetuned, whilst the concept of set-off did not change from the time of its insertion in the Napoleonic Code until 2016 when the automaticity was removed. What is also peculiar to French law is that the legislator resorted to known concepts when legislating on the close-out netting mechanism, still reflected in the term '*résiliation-compensation*', which in itself indicates that whilst there is a link with set-off, close-out netting is a broader concept. In addition, although article L.211-36-1, I of the Financial Code refers only to set-off as a modality to determine a close-out amount,

41 Pichonnaz states that the non-public order nature of set-off was accepted in a law of 1880 and its renunciation may take place either after the fulfilment of the conditions of legal set-off as at this point it is deemed that the creditor accepts to pay without reservation, or before the fulfilment of the conditions and in this case the effects of compensation do not materialise. Pichonnaz also notes that in time it became accepted that if it was not invoked before the judge, then it is presumed to have been renounced. PICHONNAZ (2001) 412 & 514.

42 See Chapter 5.2.1. Although in practical terms it may also be considered as a security of payment up to the amount covered by the set-off, it does not create any real right and for this reason has been termed as a 'simplified means of payment'. However, it is still considered as an 'indirect security' using conventional means, thereby bypassing the regulation of the types of security recognised by law which are considered burdensome to secure certain types of transactions. See DELOZIÈRE-LE FUR (2003) 39.

43 Gaudemet explains that having terminated the obligations under the first phase of close-out netting, it is only possible to consider the determination of a single payment amount if this is considered as corresponding to the prejudice caused by one of the parties in the early termination of these obligations and relative contracts. It therefore represents the contractual indemnity for the breach of the terminated contracts. According to Gaudemet, the loss is normally, but not solely, indemnified by paying the replacement value of the terminated contract in accordance with market conditions. GAUDEMET (2010) para 468.

it is generally understood that this does not imply that only set-off may be considered, but rather any modality which the parties may agree in terms of their agreement or master agreement.

A comparison between the scope of application of the two concepts is consistent with their intended rationale. There is no restriction imposed on the material and personal scope of application of set-off, being a means of payment, so that in terms of article 1347 of the Civil Code it relates to the extinction of reciprocal obligations between two persons. Thus, set-off applies in respect of any type of party and any type of obligations so long as these are fungible, certain, liquid and due, and are mutually owed between the parties. Close-out netting, being a loss indemnification mechanism, applies in respect of financial obligations concluded between parties, at least one of whom is an eligible person. Given the flexibility of fulfilment of the requirements for set-off under French law, the similarity between set-off and close-out netting is substantial. Thus, whilst fulfilment of the reciprocity requirement is strictly necessary for both concepts, it is possible for parties to set contractual valuations of their claims in relation to non-fungible obligations, even in the case of delivery obligations and to satisfy the requirement of certainty of obligations by recording the same in their contractual arrangements, at least in relation to contractual set-off. Differences between set-off and close-out netting apply in the case of obligations which are not yet liquid or payable, or in respect of future obligations. Whilst it is only possible to set off claims when the obligation has become due and payable, even with the intervention of the courts, in close-out netting it is possible to terminate or accelerate the maturity of the obligations and to contractually agree on their valuation. As in the case of English law, the termination or acceleration aspect is the most distinguishing feature between the two concepts.[44] The manner of enforceability of set-off and close-out netting is another distinguishing feature. Thus, whilst in the case of close-out netting, article L.211-40 of the Financial Code does not impose any condition for the enforceability of close-out netting arrangements, article L.622-7 of the Commercial Code provides that pre-insolvency claims should be connected for set-off to be permitted following the commencement of insolvency proceedings.[45] In terms of article L.622-17 of the Commercial Code post-insolvency claims may be set off if this is necessary for the continuation of the failing business.

Auckenthaler states that in the end close-out netting does not, strictly speaking, correspond to any specific juridical or conventional concept regulated by French law. Close-out netting permits diverse ways in which obligations concluded between two parties can be reduced to a single net payment, of which set-off is just one modality. Thus, if the parties have agreed to create a new obligation following the extinction of the old obli-

44 See in this respect BONNEAU (2017) para 934.

45 This derogation of the set-off of connected obligations, according to Gaudemet, confirms the nature of set-off as a means of payment. See GAUDEMET (2010) para 504.

gations through the novation modality, then there is no set-off.[46] Bonneau *et al*, consider that the sole fact that close-out netting is regulated by its own separate law, namely article L.211-36 of the Financial Code, implies it derives from its own original source of law which is excluded from the application of the law on collective procedures.[47]

It may be stated with sufficient certainty that close-out netting may be considered as a stand-alone concept which is not fettered in its application by any mandatory provisions of set-off and this notwithstanding the substantial similarities between the two concepts, in particular with contractual set-off. Set-off remains a possible contractual modality, amongst others, for determining a single amount, in particular in relation to global netting where it is foreseen as the sole modality to achieve a single global payment. Thus, although French law originally operated an automatic legal set-off, this was not considered a public policy rule as in the case of English law and such circumstances may have permitted the separate development of close-out netting prior to the implementation of the FCD. This development was also necessitated by the need felt by the financial community to have in place a loss indemnification mechanism for the financial markets. This may be the reason why French law, contrary to English law where the personal scope of application may be extended to agreements concluded by two corporates, always requires that at least one of the parties is an eligible person so as to maintain a link with the financial markets. On the other side of the coin, since French law extends the personal scope to agreements concluded between an eligible person and a physical person, it does not seem that considerations of systemic risk could have been the main, or at least the sole, drive for the development of close-out netting.

*US Law*

Similar to current French law, under US law the exercise of the ordinary right of set-off is a voluntary act of a non-public order nature which must be invoked by the creditor. Ordinary set-off is described by the US Department of Justice in its Attorneys' Manual as 'an equitable right' of a creditor to deduct a debt it owes to the debtor from a claim owing to it by the debtor.[48] Morton notes that in judicial proceedings, since set-off has to be invoked by the defendant, it is essentially procedural so that the defendant '*must* set up in his answer' any claim arising out of the same or different transaction or occurrence giving rise to the plaintiff's claim. However, Morton admits that

46 AUCKENTHALER (2013) para 70. In an earlier article, Auckenthaler states that netting is a combination of juridical mechanisms, whether based on the set-off concept or not, which permit the establishment of a single net amount. AUCKENTHALER (2001) para 3.

47 BONNEAU (2017) para 931.

48 See US ATTORNEY MANUAL Part 65.

what may have initially started as a procedural step may have today taken on 'characteristics of substance'.[49]

In contrast with the other two selected regimes, US law operates a rather inflexible notion of ordinary set-off in an insolvency situation. Ordinary set-off applies in respect of any type of obligations held by the same parties in the same capacity. As a general rule, ordinary set-off is governed by the insolvency law principles of the automatic stay, prohibition of creditor preferences and fraudulent transfers. By way of an exception, in terms of section 553 of the Bankruptcy Code the automatic stay is lifted for ordinary set-off in respect of connected and mutual claims which arose before the commencement of bankruptcy proceedings provided the ninety days' rule for suspect periods has been observed. Similar to the other two regimes, there is no possibility to exercise termination in relation to ordinary set-off which is affected by the automatic stay so that only pre-bankruptcy transactions may be set off against each other without court intervention. Besides the mutuality requirement mentioned above, it has been seen in Chapter 6.2.1 that ordinary set-off must also satisfy requirements related to liquidity, certainty and maturity and if not fulfilled, a solution may need to be sought through court intervention. In addition, whilst it is possible to accelerate the maturity of debts to permit the ordinary set-off of obligations that are certain or have accrued but are not yet liquidated, the courts typically prohibit the set-off of debts which are contingent on some event which has not yet occurred.

Notwithstanding the restricted flexibility in the application of the ordinary set-off concept, it is possible to conceive that the US legislator could have developed the close-out netting concept on the basis of contractual enhancements to set-off. However, it was established in Chapter 6.2.2 that it is difficult to establish this link with ordinary set-off since close-out netting has developed under the different notion of the safe harbour protection of contractual rights, which may include close-out and netting as two separate rights. Indeed, initially only the close-out aspect was protected under the safe harbours in the form of the rights to terminate, accelerate and liquidate, which rights are extraneous to the ordinary set-off concept, until in the 1990s section 560 of the Bankruptcy Code extended the protection to netting and offset rights on the basis of the same safe harbour provisions that protected close-out. This would indicate that the US legislator was not contemplating the ordinary set-off concept when considering the contractual enhancement aspects of close-out netting, but was gradually adding to the list of contractual rights to be protected under the safe harbours, until the various aspects of close-out netting started to appear together first in the said section 560 of the Bankruptcy Code and then more specifically in section 403 of FDICIA. Thus, contrary to French law where the legislator resorted to known concepts upon which to build the close-out netting concept, the US legislator built a new stand-alone concept which evolved

49 MORTON (1976) 376.

from the safe harbour protection of individual contractual rights related to financial contracts. This is also evident in the way in which the legislator created the new contractual right of 'offset' as a protected right under the safe harbours rather than as an offshoot of the ordinary set-off concept.

*Three Different Outcomes*

This part has sought to compare two particular aspects related to the set-off concept in the three selected jurisdictions, the first being whether close-out netting evolved as a contractual enhancement of set-off and the second whether the rules governing set-off in any way still apply or still shape the application of close-out netting. Arguably, the comparative analysis could not have demonstrated more diverse outcomes for the three selected jurisdictions. One commonality shared by the three jurisdictions is that the termination aspect pertains only to close-out netting and is a special feature not derived from set-off. But on other aspects, these jurisdictions have taken diverse approaches. Thus, under English law close-out netting originally derived from the set-off principle and its flexible way of operation. Indeed, with insolvency set-off being a mandatory self-executing principle, it was initially advised by English authors that close-out netting provisions should be drafted as close as possible to fall within the precepts of insolvency set-off in order to ensure its enforceability. *Ad hoc* close-out netting law was only enacted to fulfil the EU's membership obligation of transposing the FCD. It has been noted that insolvency set-off, being mandatory and self-executing, still overshadows it and, as will be seen in the succeeding part of this chapter, English authors state that it is advisable to draft the close-out netting provisions in a way which render them as different as possible from insolvency set-off, possibly devising a different contractual modality to determine a close-out amount such as novation to avoid the possibility that insolvency set-off rules take precedence. Whilst under French law the close-out netting concept was built on the existing notions of termination and set-off thereby indicating already that close-out netting goes beyond set-off since it incorporates also termination, the French legislator developed a separate close-out netting regime well before the transposition of the FCD. Over the years the legislator finetuned this regime to meet the specialised needs of the financial market, thereby manifesting its appreciation that the risks of this market cannot be adequately protected by set-off. Finally, the US legislator has chosen to develop the close-out netting concept under the separate notion of safe harbour protection of contractual rights of financial contracts. The rather inflexible nature of ordinary set-off may have contributed to this separation, also evidenced by the fact that the US legislator created the notion of offset as a contractual right under the safe harbours and did not rely on ordinary set-off. This, coupled with the lack of literature in the US discussing the link of close-out netting with ordinary set-off which can be found in respect of the other two jurisdictions, may indicate that there was never meant to be a link between the two and that close-out netting was from its inception considered to be developed on the basis of the safe harbour protection. These observations will be used in the part on Preliminary Conclusions of this chapter to reply to the first sub-question of the Introduction.

### 7.2.2 Recognition 'In Accordance With Its Terms'

Having considered from a comparative point of view the attributes and the scope of application of the concept of close-out netting and its interaction with set-off, the comparative analysis will next focus on the extent of recognition given to close-out netting provisions from two perspectives, first whether a close-out netting provision can be enforced 'in accordance with its terms' as advocated by Principle 6(1) of the UNIDROIT Principles and Article 7(1) of the FCD and, second, whether any mandatory rules continue to restrict this contractual freedom. This analysis will be restricted to the applicability of mandatory rules of set-off and insolvency law[50] and will not include consideration of the effect of resolution measures which will be considered separately later in this chapter. The areas of set-off and insolvency law have been singled out by the UNIDROIT Principles as being particularly problematic in the enforcement of close-out netting provisions in some jurisdictions,[51] though these Principles also acknowledge that:

> 'It is obvious, however, that close-out netting provisions would never be allowed to trump certain other fundamental rules, such as the rules relating to misrepresentation and fraud to the detriment of the counterparty, its creditors or the insolvent estate.'[52]

This part will first consider the role played by contractual freedom under the main close-out netting rules of the three selected regimes and will then consider any restrictions imposed by their set-off and insolvency law regimes on the exercise of party autonomy. The observations made in this part will be used to provide replies in the Preliminary Conclusions to the first and second sub-questions of the Introduction.

*'In Accordance With Its Terms'*

Under English law, the recognition of close-out netting provisions is influenced by a combination of the transposition of the FCD and the application of certain rules governing insolvency set-off. Regulation 12(1) of the FCAR provides that a close-out netting provision which forms part of a financial

50 It is thus not within the scope of this analysis to consider general contact rules which must be complied with, such as contractual capacity, or other national laws which may in any way restrict or effect the exercise of party autonomy.

51 See UNIDROIT 2013 Close-out Netting Principles paras 110 & 115.

52 *Ibid.* para 112. This is being stated in relation to Principle 7(2).

collateral arrangement takes effect 'in accordance with its terms' notwithstanding the commencement of winding-up or reorganisation procedures. This provision is clearly based on Article 7(1) of the FCD. On the other hand, sub-regulation (2) of the same regulation provides an exception to this rule in cases where the financial collateral arrangement or the relevant financial obligation was created at a time when the solvent party was aware or should have been aware of the commencement of winding-up or reorganisation procedures. This may have been influenced by the provisions on insolvency set-off then applicable under the former rule 4.90 of the Insolvency Rules 1986 (also applicable today) which disallows set-off if there is actual knowledge of an impending insolvency. Subject to the conditions imposed by regulation 12(2) of the FCAR, a close-out netting provision is enforceable 'in accordance with its terms' only if it falls within the scope of the FCAR, implying that the close-out netting provision should form part of a financial collateral arrangement. Beyond the scope of the FCAR, a close-out netting provision does not benefit from this standard of party autonomy but becomes subject to the mandatory provisions of insolvency set-off. Given the prevalent view in English doctrine that insolvency set-off law is sufficiently flexible to grant the necessary protection to close-out netting provisions, the English legislator chose to transpose faithfully but narrowly the provisions of the FCD with the result that recognition of contractual freedom is restricted to close-out netting provisions forming part of financial collateral arrangements, with the further restriction imposed by the legislator of the absence of knowledge or constructive knowledge of an impending insolvency.

Contrary to the English law situation, the French legislator started to enact specific close-out netting legislation well in advance of the implementation of the FCD. It may be for this reason that the French close-out netting regime is not restricted in scope to the close-out netting provision being part of a financial collateral arrangement. The expansion of the recognition of close-out netting provisions was initially targeting specific financial contracts[53] and at these early stages recognition may be considered restricted. Thus, under the former triple close-out netting regime, there were no restrictions imposed in relation to securities lending other than that the operations had to be governed by a standard national or international master agreement, repo agreements had to be approved by the central bank Governor and under the third regime the operation of financial instruments had to be governed by the framework of rules of the relevant market association or by a master agreement respecting the general principles of national or international master agreements.[54] Also, it was initially only in the case

53 It has been seen in Chapter 5.3 that close-out netting regimes in France were enacted in 1987 in relation to the securities lending market, in 1993 to the futures market and in 1994 to the repos market.

54 See LE GUEN (2001) 43.

of the futures market that a close-out netting provision was enforceable notwithstanding the opening of insolvency proceedings. Standardisation of close-out netting as a regime was achieved in 2001 with the setting up of a single close-out netting regime which was conditional on one of the parties being an eligible financial markets party.[55] This was complemented by the introduction of global netting in 2001 which was considered as a major step in the protection of close-out netting at the time, though initially a connexity between the obligations had to be established by contractual provision, reminiscent of the requirements of set-off. Following the recognition of all modalities of termination, evaluation and set-off stipulated by contract in the 2005 law implementing the FCD,[56] it became important to clearly stipulate in the agreement all the details required to make the close-out netting effective, such as the way in which amounts in different currencies are to be evaluated and the contractual provisions linking the close-out netting of various products or of various netting arrangements in order to enable the global netting to take place. Thus, it can be acknowledged that the FCD had an important role in reinforcing the party autonomy role in the French close-out netting regime. However, on account of the need for the contract to stipulate certain details, it became the practice for French counterparties to resort to national or international master agreements in place for a particular financial product which could be relied upon to satisfy this requirement.[57] As a result, although in its current form, article L.211-36-1 of the Financial Code gives a full role to party autonomy which is equivalent to the 'in accordance with its terms' standard, it would appear that in practice French counterparties still operate under the old regime where recourse was required to be had to the standard master agreements.

Contrary to the gradual liberalisation of close-out netting under French law, the protection of the contractual rights of close-out and netting under section 560 of the Bankruptcy Code may be considered to have been fully liberalised from the start. Typical of all the US safe harbours, the enforceability of close-out netting goes beyond contractual arrangements and includes the protection of rights 'whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.' Thus, US law protects close-out netting both if it results from a written contract as well as from a business practice. This may appear similar to French law which recognises the modalities of termination, evaluation and set-off which *may* derive from an agreement or master agreement, thus giving rise to the interpretation that these may arise from sources other than an agreement or master agreement but do not exclude the latter.

55 It was extended to include public entities under the regime of former article L.431-7 of the Financial Code.

56 In fact, it has been seen in Chapter 5.3 that the major influence of the FCD upon French law has been in relation to the increase in the type of financial obligations falling within the scope of the close-out netting regime.

57 JURISCLASSEUR (2013) Fasc. 2050, paras 79 & 83.

But whilst French law gives full effect to the modalities as stipulated by contract, the protection given under section 560 of the Bankruptcy Code is that contractual rights 'shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.' Although this protection is significant, it cannot be said to be equivalent to the standard of granting protection to a close-out netting provision 'in accordance with its terms' as is more clearly stipulated in section 403 of FDICIA. Section 403 of FDICIA has sought to codify the US close-out netting regime insofar as regards major dealers who enter into netting agreements. When recognising close-out netting provisions, section 403 of FDICIA provides for the enforceability of the netting of payment obligations under a netting contract '[n]otwithstanding any other provision of State or Federal law', other than stipulated provisions relating to resolution measures, and 'in accordance with, and subject to the conditions of, the terms of any applicable netting contract (except as provided in section 561(b)(2) of title 11)', the latter relating to certain obligations entered into in relation to commodity contracts governed by the Commodity Exchange Act. It is therefore now clearly the case that US law also protects a close-out netting provision 'in accordance with its terms', at least for those dealer agreements which fall within the scope of application of section 403 of FDICIA.

*Mandatory Set-off Rules*

A major distinction in the set-off law of the three selected jurisdictions is that set-off is subject to the voluntary act of the creditor under French and US laws, whilst it is mandatory and self-executing under English law. French law changed from a mandatory to a voluntary set-off system following amendments to the Civil Code in 2016. This distinction in the nature of set-off is expected to significantly influence the close-out netting regimes of these jurisdictions.

The mandatory and self-executing nature of insolvency set-off under English law implies that it will replace a close-out netting provision in circumstances where the requirements for the application of insolvency set-off are fulfilled. This position has been confirmed in the FCAR consultation document where it is stated that the former rule 4.90 will continue to apply to financial collateral arrangements.[58] Notwithstanding this general assertion, two important points should be noted in relation to the role of insolvency set-off. First, it has been seen in Chapter 4.3 that although the FCAR regulations 12(4) & 14 disapply certain provisions on insolvency set-off rules, this does not mean that the rest of the provisions on insolvency set-off are applicable. This seems to be the established interpretation even though it would seem rather odd to exclude only certain provisions when

58 HM TREASURY 2003 FCAR Consultation Document, para. 5.9.

all should be excluded. Second, it is difficult to understand when insolvency set-off may replace close-out netting given that one important constitutive element of close-out netting, namely the termination element, is missing from the constitution of insolvency set-off. Basing themselves on the experience of the administration of Lehman Brothers International, Yeowart *et al.* state that set-off may replace close-out netting if before contractual close-out netting takes effect, notice is given by the administrators of the defaulting parties of their intention to make a distribution or an order is made for the winding-up of the defaulting party. In these circumstances, insolvency set-off could occur before the non-defaulting party has given notice of early termination. The non-defaulting party will then find its transactions valued in accordance with insolvency set-off rules.[59] One solution suggested by Gullifer to avoid replacement is to ensure that the close-out netting provision does not operate by way of set-off but that the contracts are terminated and replaced with a new obligation to pay the net amount.[60] Gullifer refers, *inter alia*, to paragraph 5.9 of the FCAR consultation document cited above to support her argument. As a counterargument, however, one may raise three points. First, any reference to set-off as a modality to determine a single amount is to contractual set-off and not insolvency set-off. If the close-out netting provision is effective, the contractual set-off may be freely used to determine a single amount without fear that it is replaced by insolvency set-off. Second, it has been seen at the beginning of this research that whilst some types of transactions are better served by a set-off clause for executing the third step of close-out netting, others are more adapted to the determination of a single payment amount using the novation modality. Hence, it may be difficult to take the novation modality as a definite way of establishing a single payment amount. Third, insolvency set-off is self-executing and, it is understood, depends on the applicable circumstances and not on contractual arrangements. It is therefore argued that it should not matter that the close-out netting provision does not refer to set-off as a modality to determine a single payment amount since insolvency set-off will anyway apply if relevant requirements are fulfilled. It is rather an issue of timing and of whether the conditions for insolvency set-off to apply have been fulfilled prior to the exercise of the termination phase of close-out netting.

Under French law, on the other hand, set-off law does not appear to have any implications on the manner in which the contractual modalities of termination, valuation and set-off under article L.211-36-1 of the Financial Code may apply, provided all details necessary for their effectiveness have

---

59 YEOWART *et al.* (2016) 233. Firth recommends that close-out netting should be drafted in a way as to fulfil the requirements of insolvency set-off so that the agreement can still be upheld in the event of a liquidation or a distribution by an administration. FIRTH (2013) para 5.068. This, however, would deny to the close-out netting provision all the contractual enhancements it is meant to achieve.

60 GULLIFER (2017) 386.

been stipulated by contract or other type of arrangement. No requirements are imposed in relation to the actual or constructive knowledge of the impending insolvency as is the case under English law and neither does the law impose any element of reasonableness in the drafting of these modalities. Given that there is no notion of insolvency set-off under French law and that set-off of any kind should be invoked by the creditor, if the same creditor may also benefit from a close-out netting provision, then depending on the circumstances and fulfilment of applicable requirements, the creditor may choose to either invoke set-off or exercise its rights under the close-out netting provision. This is the case since set-off, like close-out netting, is a voluntary act subject to the will of the creditor invoking it.

Similar to the situation under French law, ordinary set-off has to be invoked under US law and, being a voluntary act, the creditor decides which netting mechanism to resort to, provided the requirements or contractual conditions of the selected mechanism have been fulfilled. Under the US safe harbours, contractual rights are given full protection of the law provided the right falls within the scope of application of these safe harbours. The question in this case, which also arises under the other laws, is to define those circumstances where both concepts can be applied alternatively given that one of the constitutive elements of close-out netting is the termination or acceleration of outstanding obligations. It is arguable that either there is the need to terminate and then only close-out netting applies, given that section 560 of the Bankruptcy Code and section 403 of FDICIA refer to netting as related to close-out positions, or ordinary set-off can take place since there is no need to terminate. In the latter case, it is then difficult to conceive how close-out netting may be exercised. It would therefore seem that under US law circumstances might dictate whether it is possible to use one concept instead of the other and this is especially the case in administration whether the bankruptcy trustee may decide to exercise ordinary set-off before the creditor has the opportunity to operate the close-out netting provision.

### *Mandatory Insolvency Law Rules*

The carve-outs benefitting close-out netting provisions are typically related to the disapplication of insolvency rules in line with the general understanding that it is upon insolvency that the enforcement of a close-out netting provision is mostly problematic given the mandatory nature of most national insolvency principles. On the other hand, as declared in the UNIDROIT Principles, such carve-out should not extend to cases where a close-out netting provision is entered into with the knowledge of an impending insolvency proceeding or in order to affect the ranking of categories of claims or to avoid a transaction as a fraud to creditors.[61] The

61 See UNIDROIT 2013 Close-out Netting Principles, Principle 7(2).

purpose of this part of the comparative analysis is to examine whether for the three selected jurisdictions the carve-out is all-encompassing, subject to the application of the safeguards suggested by the UNIDROIT Principles, or whether any insolvency rules continue to restrict the enforcement of close-out netting provisions.

In terms of English law, although regulations 8 and 10 of the FCAR disapply a number of insolvency law provisions in relation to financial collateral arrangements and close-out netting provisions falling within the scope of the FCAR, the disapplication is incomplete and a number of provisions of the Insolvency Act 1986 still apply. Most of these provisions signify an element of fraudulent intent on behalf of the solvent party and thus are in accordance with the UNIDROIT Principles cited above. According to Yeowart *et al.*, the FCAR 'leaves unaffected the general rules of national insolvency law in relation to the avoidance of transactions entered into during a prescribed period', which is typically two years prior to the commencement of insolvency or reorganisation procedures. Thus, according to these authors, it is possible, depending on circumstances, for a transaction to be challenged under the Insolvency Act 1986 for reasons that it was made at an undervalue under section 238, is a preference under section 239, is exceptionally a contract which should be rescinded by the court under section 186 or is a transaction defrauding creditors under section 423. These authors confirm that in each of these cases, there are certain requirements that must be met such as, for instance, in relation to preference there must be an intent to prefer the relevant creditor.[62] Firth raises the question whether the close-out netting provision itself, which is intended to improve each party's position in case of insolvency, can ever survive the test of the preference rules. Firth argues that since at the time of entering into the agreement none of the parties is yet a creditor or debtor of the other given that no transactions have yet been entered into, the entering into the close-out netting agreement in these circumstances cannot be said to constitute a preference for any of the parties.[63]

French law provides full protection under article L.211-40 of the Financial Code to article L.211-36-1 of the Financial Code from the provisions of book VI of the Commercial Code dealing with insolvency and from equivalent judicial or amicable procedures instituted under foreign laws. Gaudemet states that the general view in French doctrine is that although there should not be obstacles to the enforceability of a close-out netting provision on account of article L.211-36-1 of the Financial Code, given the systemic impact of these provisions an express exclusion provides the necessary comfort and legal certainty.[64] This derogation implies that a close-out netting provision is not affected by the stay which applies upon

62 YEOWART *et al.* (2016) 99.
63 FIRTH (2013) para 5.056.
64 GAUDEMET (2010) para 517.

the opening of a judicial reorganisation, safeguard or amicable proceeding as well as from the powers of the administrator to demand the execution of current contracts in terms of article L.622-13 of the Commercial Code as well as from the cherry-picking powers of the administrator. It also makes a close-out netting provision unchallengeable under the provisions relating to suspect periods under articles L.632-1, L.632-2, L.621-107 and L.621-108 of the Commercial Code. According to Terret, these derogations would seem to give the enforcement of close-out netting provisions the nature of a public order rule.[65] Roussille, however, cautions that since these are derogations from a number of important public rules of the law of collective procedures and the principles of the general equality of creditors, they must be narrowly construed.[66] Although this statement is in accordance with interpretation rules, it has to be noted that the wording of article L.211-40 of the Financial Code is construed in sufficiently wide and emphatic terms (‘*ne font pas obstacle*’) as to overcome any doubt of interpretation in favour of upholding the enforcement of a close-out netting provision in the light of any conflict with insolvency rules regulated by book VI of the Commercial Code.

Under US law, the derogation in favour of close-out netting in relation to insolvency law is stipulated in both sections 560 of the Bankruptcy Code and 405 of FDICIA. Section 560 of the Bankruptcy Code provides that the exercise of contractual rights ‘shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceedings under this title’, thus limiting the derogation to proceedings under the Bankruptcy Code. By way of practical application of this derogation, Roe states that the main derogations would regard the following: first, relevant counterparties can immediately enforce their claims at the beginning of the bankruptcy and are not impeded by the stay. Second, relevant counterparties do not need to return ‘eve-of-bankruptcy’ payments on old debts nor forfeit seized preferential collateral. Third, they have broader offset and netting rights that allow them to escape handing over money they owe to the debtor. Fourth, they are exempt from most fraudulent conveyance liability. Fifth, they can choose whether or not to terminate contracts under *ipso facto* clauses. Sixth, they need not suffer the debtor’s typical bankruptcy option to assume or reject the underlying contract.[67] In line with the UNIDROIT Principles, these derogations exclude any action taken with actual intent to hinder or defraud other creditors.[68] A similar exemption is provided by section 405 of FDICIA which provides that:

65 TERRET (2005) 53.

66 ROUSSILLE (2001) 315.

67 ROE (2011) 547. In this respect see also ROE & ADAMS (2015) 378; SCHWARCZ & SHARON (2014) 1718; LUBBEN (2009) 65.

68 See section 546(g) of the Bankruptcy Code.

> 'No stay, injunction, avoidance, moratorium, or similar proceeding or order, whether issued or granted by a court, administrative agency, or otherwise shall limit or delay the application of otherwise enforceable netting contracts in accordance with sections 4403 and 4404 of this title.'

This provision appears to be more comprehensive than section 560 of the Bankruptcy Code which only protects contractual rights from the provisions of the Bankruptcy Code. On the other hand, it has been seen that section 403 of FDICIA is more limited in personal scope than section 560 since it applies where both parties are major dealers. This or similar situations may have led to the statement made by Schwarcz and Sharon that 'exemptions sometimes lacked coherence, with rights available to counterparties differing from one financial product to another without clear economic rationale.'[69]

Following this comparative analysis, it can be said that whilst all three jurisdictions ensure a high level of protection for close-out netting provisions, the manner in which this is achieved differs between the three jurisdictions. English law does so on the basis of the implementation of the FCD, having formerly based the enforcement of close-out netting provisions on the flexible but mandatory rules of insolvency set-off. As a consequence, the recognition of close-out netting provisions under English law is based on the premise that the close-out netting provision forms part of a financial collateral arrangement. French law operated a specialised close-out netting regime before the implementation of the FCD. Recognition of close-out netting provisions under the old regime was, however, somewhat curtailed by the need to fulfil the requirements of industry bylaws, obtain authority permission or be based on standard national or international agreements in place for the respective financial product market. The regime was further liberalised following the implementation of the FCD, although the French legislator chose not to restrict its scope of application to financial collateral arrangements given that the former regime was not restricted in this way. Close-out netting rights under US law benefitted from the expanding protection given to contractual rights under the safe harbours and the wide scope of application of section 560 of the Bankruptcy Code and seemed to have benefitted from a liberal protection of party autonomy from inception, which was later strengthened by the enactment of section 403 of FDICIA.

In relation to the effect of set-off law on the recognition given to close-out netting provisions, English law operates a self-executing, mandatory insolvency set-off regime so that the latter displaces close-out netting when the conditions for insolvency set-off concur. Under French and US laws set-off has to be invoked in order to apply and hence it would seem that the creditor in these jurisdictions has a choice whether to invoke set-off or close-out netting rights. Under the three jurisdictions the faculty to terminate contracts is only available in close-out netting and if termination or acceleration is necessary, then the determination of a single amount through

69 SCHWARCZ & SHARON (2014) 1731.

ordinary set-off may be unfeasible. It seems that the most likely case where set-off may replace close-out netting arises where notice has been served on the creditors following the issue of a winding-up or administration order and the insolvency practitioner is able to invoke set-off through powers given by the law before the creditor has been able to give notice of early termination. In this case, it does not matter whether the set-off system is mandatory or not, but it is a matter of timing of the exercise of close-out netting rights.

In relation to the effect of insolvency law, whilst the English and US regimes allow for some form of insolvency law restrictions to apply, these mostly relate to fraudulent actions that are taken by the creditor and may be considered to conform to the type of fraudulent exceptions advocated by the UNIDROIT Principles considered above. It was also seen that US law grants different levels of protection to party autonomy, depending on the applicable regime. No restrictions seem to specifically apply to the French regime which recognises any modality of termination, valuation and set-off, although it is presumed that the maxim *fraus omnia corrumpit* could be made to apply. On the other hand, the specific derogations under French and US laws from their respective insolvency regimes have raised questions whether this implies that other non-insolvency regimes will continue to apply or whether the declaration that contractual modalities of close-out netting provisions will be upheld is sufficient to overcome any restrictions arising under these non-insolvency regimes.

## 7.3 Fulfilment of State Insolvency Goals

This last part of the comparative analysis will consider whether the recognition given to close-out netting provisions is meant to serve declared or implied State insolvency goals. This will be achieved in the first part by analysing whether a strategic decision was taken by the legislator, or where applicable, by the courts, to link the special treatment given to close-out netting to the attainment of a public policy. The second part of this comparative analysis will focus on the effect of resolution regimes on close-out netting in order to establish any convergence or standardisation in the type of restrictions imposed on the exercise of close-out netting rights and what was the drive for this convergence.

### 7.3.1 Congruence with State Insolvency Goals

Whilst historical events may have shaped much of today's national insolvency law, the evolution of public policies and approaches continue to influence its development and its impact on other branches of national law. From a historical perspective, the handling of and the attitude towards the insolvent debtor have varied in the three selected jurisdictions. Early English insolvency law was characterised by punitive measures against the debtor and it was only in the early eighteenth century that rehabilitation started to be recognised when a 1705 statute relieved traders of liability for existing debts, even though seizure of person or property was still possible.[70] Although the Enterprise Act of 2002 heralded the rescue culture, it has been stated that the 'present English rescue procedures might be portrayed as giving strong priority to the protection of creditor interests and limited priority to rescue […].'[71] The foundation of French insolvency law under the Commercial Code of 1807 was also based on the punishment of trader debtors, although this initial regime already started to be relaxed under the Act of 28 May of 1838.[72] French law is traditionally considered hard on creditors as they did not have a say in most insolvency decisions, the main reason being that the law is directed towards securing jobs by keeping troubled firms alive. The situation changed significantly with the introduction of the preservation procedure in 2005 which gave creditors a say in the approval of a rescue plan through creditors' committees for businesses above a certain threshold. In the US, Chapter 11 of the US Bankruptcy Code is described as 'strongly oriented to the avoidance of the social costs of liquidation and the retention of the corporate operation as a going concern' and the process is 'an instrument for debtor relief, not a remedy for creditors'.[73] Preservation of the company reflects the US concern to encourage investment in entrepreneurial ventures. These different approaches are the result of different value judgements made by the legislators towards the failing debtor and the protection of the creditor. This comparative analysis will serve, together with the analysis on the influence of insolvency law on the recognition of close-out netting provisions made in part 7.2.2 of this chapter, to provide replies in the Preliminary Conclusions on the second sub-question of the Introduction.

*English Law*

Rather unique circumstances surround the advent of the close-out netting regime under English law. Whilst in the other two selected jurisdictions the legislator created the close-out netting concept on the basis of a combination of existing concepts, the common understanding of English practitioners prior to the enactment of the FCAR was that close-out netting already worked under the mandatory, but flexible, insolvency set-off regime. This approach would indicate that limited consideration has been given to the contractual enhancement features of close-out netting and there seems to have been little understanding of its constitutive features, in particular of the termination feature which cannot be achieved on the basis of insolvency set-off. It has been seen that the implementation of the close-out netting

70 FINCH & MILMAN (2017) 8.
71 *Ibid.* 278.
72 Philippe Théry, 'The Evolution of Insolvency Law in France', in RINGE (2009) 2.
73 *Ibid.*

rules in the FCAR in 2003 was also considered unnecessary on the understanding that there were no formalities or other obstacles to the enforceability of close-out netting because of its assimilation with insolvency set-off. As a result of all this, it may be difficult to gauge the moment in time when a policy decision was taken, if at all, by the English legislator which may help to understand the rationale for the special treatment, other than to conclude that according to the English legislator close-out could already operate within the confines of insolvency law and its implementation in the FCAR was merely necessary to fulfil the EU obligation to transpose the FCD.

Indeed, a number of features of the close-out netting protection are congruent with the notion of 'references' typically allowed under English law. It has been seen in Chapter 4.4.1 that the protection given to close-out netting under the FCAR falls within the ambit of protection afforded to pre-contractual entitlements under English law, so long as the conditions of regulation 12(2) on actual or constructive knowledge of the pending insolvency do not materialise. It has also been seen that although a number of writers argue that the recognition given to close-out netting rights goes against the notion of *pari passu* which underlies the English insolvency system, it has been counterargued that the preference given to holders of close-out netting rights is one manifestation of formal equality in insolvency law which is determined by pre-insolvency law. According to this interpretation, what cannot be contracted out of is the whole collective system for the winding-up of insolvent estates but it is possible for the law to recognise a priority standing for a particular class of creditors.

However, without specific legislative recognition there remained much uncertainty about the applicability of the contractual enhancements of close-out netting. For instance, prior to the enactment of the FCAR the multilateral arrangement for the settlement of payments in the *British Eagle* case was considered as a means of 'contracting out' of the provisions of section 302 of the Companies Act 1948 for the payment of unsecured debt *pari passu*. On the other hand, English law may be considered willing to accommodate contractual innovations. Thus, some reliance could be placed on the English law principle that a contractual device should not be regarded as offensive if it is intended to operate in the same way outside and inside insolvency as it is not a device designed to improve the position of one party by reason of the insolvency of another, even though this argument was not accepted by the majority opinion in *British Eagle* in relation to the multilateral payment scheme. It is also to be noted that in the *BCCI (No 2)* case the court was ready to use imaginative judicial reasoning by finding a personal liability on the part of a director when guaranteeing the debts of the debtor company since this was perceived to lead to a just result. It would appear that where a commercially justifiable reason exists for a clause and there is no deliberate attempt to evade the insolvency laws, the English courts are prepared to give favourable consideration to such clause. These and other equitable principles, together with the strong pre-contractual protection culture, may have provided sufficient comfort to the market that close-out netting worked without the need to resort to *ad hoc* close-out netting law.

This conviction of the workability of close-out netting under English law is reflected in the way in which the FCD has been implemented through the FCAR. Contrary to the situation under French and US laws, the English legislator did not consider it necessary to extend the scope of application for the recognition of close-out netting provisions beyond the confines of financial collateral arrangements. On the other hand, the legislator did not hesitate to widen its personal scope to include arrangements concluded between two corporates on the assumption that this would be in accordance with English law overall objectives.[74] The widening of the personal scope in this way results in protection being given to close-out netting provisions which goes beyond the purpose of operating sound risk management practices as advocated by the Recital (14) of the FCD since the personal scope has been arguably set to fit the wider financial collateral regime served by the FCAR. Even the declaration made in the FCAR consultation document that the flexible approach taken to implement the FCD is intended to promote London as a global financial market[75] is presumably made in relation to the use of financial collateral arrangements rather than specifically to the recognition of close-out netting provisions. It appears that no specific goal has therefore been set for the way in which close-out netting considered on its own has been implemented. Given the close affinity with the traditional goal of enhancing creditors' rights evidenced in particular by the general principle on the respect for the pre-insolvency contractual entitlements, the recognition given to the contractual enhancements can easily fall within the scope of this goal. This is coupled with the understanding that close-out netting under English law is heavily impacted by insolvency set-off as a notion and which as a right is available to any party, whether financial, corporate or individual.

*French Law*

Whilst there may be congruence for the preferential treatment given to netting creditors with State insolvency goals under English law, the same cannot be said for French law. French law does not consider pre-insolvency contractual entitlements favourably. Following the introduction of the judicial restructuring procedure by the law of 13 July 1967, secured and

74 HM TREASURY 2003 FCAR Consultation Document, para 2.2.

75 *Ibid.* para 1.12: '[…] 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.'

unsecured creditors were treated without distinction.[76] With the introduction of the safeguard procedure in 2005 and of the accelerated financial safeguard procedure in 2014 priority was again given to the restructuring of the business over the protection of creditor interests. Also, the application of French insolvency law principles is rather distinctive in comparison with the other two jurisdictions. Thus, although French law operates a 'freeze' on creditor action, this only regards creditors whose claims originate prior to the commencement of collective proceedings. Claims arising after the commencement are paid without delay if they are properly incurred for the restructuring of the failing business. This state of affairs whereby claims arising after the commencement of insolvency proceedings may be settled immediately may help explain the erosion of the *pari passu* principle under French law and the marked absence of requirements tied to the actual or constructive knowledge of the impending insolvency.

Against this background of priority given to the rescue of the failing business, a stark contrast exists with the preference given to netting creditors. Arguably the main reason for this turnaround advanced by both doctrine and politicians in France is that the protection to netting creditors is based on economic reasons and is required to enhance the competitiveness of the French financial market. It has been seen in Chapter 5.4.2 that on the occasion of the commemoration of the bicentenary of the Commercial Code in 2007, former President Sarkozy declared that commercial justice should be at the service of the dynamism of the French economy and should be inspired by the US Chapter 11 model in order to encourage entrepreneurs to develop initiative and the taste for risk. Synvet acknowledges that the aim for the derogations was initially to strengthen legal certainty for operators, to limit counterparty risk and to avoid chain defaults that could lead to the commencement of collective proceedings against one of them. Synvet considers that it is difficult to justify the protection of close-out netting on the grounds of systemic risk when its protection is extended to agreements concluded by any corporate or physical person with an eligible party.[77] He concludes by commenting that '[t]he truth is that it is a matter of giving French banks a competitive advantage in international competition, even at the price of sacrificing the interest promoted by the law of businesses in difficulty.'[78] On the other hand, Gaudemet notes that under the

76 This happened because secured creditors were required to submit their claims for verification and this was used by the courts as a pretext for applying the stay of individual actions to them, as well as the prohibition of enforcement proceedings until their claims were admitted. Cass Ass plén, 13 February 1976, Bulletin civil Ass plén, no 3, p 4. See Hervé Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', in RINGE (2009) 161.

77 It should be noted, however, that close-out netting provisions concluded between an eligible party and a very large corporate may still entail risk of systemic proportions.

78 Hervé Synvet, 'The Exclusion of Certain Creditors from the Law of Collective Proceedings', in RINGE (2009) 163 & 179.

cover of measures against systemic risk, French law has imported English concepts which are traditionally favourable to creditors of a debtor in difficulty, bringing into question whether the law of insolvency proceedings can remain based on the objective of the debtor's reorganisation and the principle of equality among creditors.[79]

The theory advocated in this research is that possibly there are two rationales for the way in which close-out netting developed in France. The first regards the period of time preceding the transposition of the FCD when the French close-out netting regime was developed to serve as a loss indemnification mechanism for the financial markets. This is evidenced especially by the initial focused attention to the requirements of the individual markets and by the condition imposed by the various regimes that close-out netting provisions should be based either on industry bylaws or on national or international master agreements in place for that particular market. Even with the unification of these separate regimes into one, the law still imposed the requirement of compliance with the regulations or master agreements in place for the industry. The various changes to the close-out netting regime, in particular the establishment of a single regime and the extension to global netting both in 2001 generated intensive debate on how far to extend the liberalisation of the close-out netting regime in order to protect the market from losses. Although the contractual modalities of termination, valuation and set-off were consistently protected from the application of insolvency law, prior to the implementation of the FCD this was the case provided the close-out netting provision was consistent with the regulations and standard agreements of the market. Hence, the basis of the protection was self-regulation by the market.

Upon implementation of the FCD, the close-out netting regime became more liberal. Although the law still speaks in terms of the modalities of termination, valuation and set-off when referring to close-out netting, a break with the past seems to have taken place upon implementation of the FCD in 2005 where reliance was no longer placed on existing standard agreements or industry bylaws. The Report to the President on the law implementing the FCD[80] reflects the intention of the legislator to widen the scope of the regime and to delete existing restrictions under French law. Of course, this position was taken in relation to the whole financial collateral regime under the FCD, but certain changes made by the French legislator indicate that specific decisions were also taken in respect of the close-out netting regime, such as the option made in relation to the personal and material scope of application and the decision not to restrict the close-out netting provision to the confines of a collateral financial arrangement . This

79 GAUDEMET (2010) paras 564 & 567.

80 *Rapport au Président de la République relative à l'ordonnance no 2005-171 du 24 février 2005 simplifiant les procedures de constitution et de realisation des contrats de garantie finacière*, NOR: ECOX0400308P.

widened French regime may go beyond the scope of the FCD of putting in place sound risk management practices and is arguably explained by the desire of the legislator to be as competitive and flexible as other jurisdictions in the field of the financial markets.

*US Law*

The US bankruptcy regime, similar to the French regime, is not generally speaking favourable to the creditor. The rationale of US bankruptcy law is based on the notion of the discharge for the debtor with the ultimate goal being to encourage risk-taking in order to foster entrepreneurship. It has been seen in Chapter 6.4.1 that the US insolvency law principles protect the going-concern value of the insolvent debtor by imposing a stay on individual creditor action, the annulment of fraudulent conveyances of the debtor's assets and a ban on *ipso facto* clauses that make the filing of a petition for bankruptcy an event of default. US law is not based on the recognition of pre-insolvency entitlements and most creditor claims are also subject to the debtor's or bankruptcy trustee's power to assume or reject contracts, even though this is subject to court approval. This allows the debtor to maximise the value of its own business.

The legislative treatment of the safe harbours is contrary to the scope of US bankruptcy law since it promotes the individual pursuit of claims and the seizing of collateral up to the eve of bankruptcy without the need to observe any suspect period. This could easily frustrate going-concern value and debtor rehabilitation since power is taken away from the debtor or bankruptcy trustee and given to the netting creditor to pursue its individual claims. Officially, the need for the safe harbours has been based on the avoidance of systemic risk. The US legislator has deemed that financial contracts should not be subject to the delays of the Bankruptcy Code since they must be actively traded on the market and are subject to the risks of fluctuating values inherent in the financial markets. A number of critics have argued that following the enactment of the first safe harbour in relation to the commodities and forward contracts, the further extensions of this initial safe harbour are to be considered as path dependent. In such circumstances, it is difficult to trace whether the development of the enforceability of close-out netting is the result of a conscious decision taken by the legislator to pursue a defined public policy in the light of the rationale of US bankruptcy law.

Schwarcz, a proponent of the path dependency view, notes that:

> 'The derivatives safe harbor, at least in part, is an outcome of decades of sustained industry pressure on Congress to exempt the derivatives market from the reach of bankruptcy law, with each exemption serving as an historical justification for subsequent broader exemptions'.

Schwarcz notes that whilst the first safe harbour of 1978 was very narrow in scope and was based on one case cited before Congress, this served as a precedent for further expansions of the safe harbours.[81] Edwards and Morrison, critics of the risk systemic theory, observe that the fear of derivatives-induced systemic risk is warranted only in the case of an insolvency of a major financial market participant holding a massive derivatives portfolio.[82] The safe harbour exemptions, however, operate independently of the size of the counterparty or its portfolio. In addition, they apply not only to financial firms but to any firm that holds a derivative.

It is important to bear in mind that the US legislator was not specifically targeting the protection of close-out netting when establishing the first safe harbours, rather the US legislator was protecting the exercise of contractual rights in relation to financial contracts. This makes it more difficult to understand the goal aimed to be achieved by the derogations granted in favour of close-out netting. Indeed, the protection to both close-out and netting as contractual rights first took place in the 1990s by the enactment of sections 560 and 561 of the Bankruptcy Code in relation to swap and master agreements, and this came at a time when the lobbyist movement led by ISDA was putting pressure on legislators to ensure that the effectiveness of close-out netting arrangements in relation to the newly-emerging derivatives market 'would not be prevented by the automatic stay'.[83] The establishment of a legally sound close-out netting regime in the US would have been an excellent trendsetter for other legislators to follow suit.

It is difficult to establish a single State insolvency goal that was meant to be achieved for the special treatment given in the safe harbours under US law since there are various levels of protection afforded by law. Thus, although the US legislator has stipulated that the safe harbours were required to mitigate against systemic risk, this may be seen to apply in certain instances but not in others. Following from this, the path dependency theory may be perceived to apply in certain instances but not in others. Thus, the first time that close-out netting was protected in 1990 through section 560 of the Bankruptcy Code, the US legislator might have been acting under the impression that the swap safe harbour as drafted was required to prevent systemic risk but the wide terms in which it is construed and the fact that it applies to any participant to a swap agreement, itself widely defined, does not make the systemic risk goal very credible. On the other hand, it appears that some assessment of systemic risk was made in the definitions of financial participant under the BAPCPA of 2005 and of financial institution under Regulation EE issued by the Federal Reserve under section 402 of FDICIA since both these terms impose high thresholds of business that must be transacted by the counterparty to benefit from the safe harbours to which they refer. As a result, there apply in parallel

81 SCHWARCZ (2015) 703.
82 EDWARDS & MORRISON (2005) 98.
83 SCHWARCZ & SHARON (2014) 1730.

two different regimes. Those safe harbours which fall squarely within the parameters of section 560 of the Bankruptcy Code have a wide scope of application which is difficult to justify under the system risk goal since they apply to any party to a swap agreement. This can be either explained as informational blindness in terms of the path dependence theory or it reflects the entrepreneurship spirit of the US legislator which encourages risk-taking, although the latter assumption is unlikely since section 560 of the Bankruptcy Code was enacted for the declared purposes of averting risk. On the other hand, counterparties to transactions not falling under the swap agreement definition of section 560 of the Bankruptcy Code and who qualify as either financial participants under BAPCPA or financial institutions under FDICIA face a size or threshold test which may be assumed to serve the systemic risk goal sought to be achieved by the US safe harbours. It is difficult to identify a one-size-fits-all goal for the Bankruptcy Code and the FDICIA regimes and it would have been of great benefit had the legislator amalgamated them into one coherent regime.

*Three Different State Insolvency Goals*

The comparative analysis of the State insolvency goals set by the legislators of the three selected jurisdictions for the special treatment given to close-out netting indicates that there is no convergence of public policy approaches in this respect. Some common aspects in the historical development of the respective insolvency laws of these jurisdictions have been identified. Thus, whilst both the English and French regimes historically sought to punish the insolvent trader, the US legislator has since early times been prone to discharge the insolvent trader in order to encourage entrepreneurship through risk-taking. Currently, all three jurisdictions have their own restructuring regimes which target the rehabilitation of the debtor or its business. However, fundamental differences exist in the way in which the regimes treat creditors' rights, with the English legislator being a staunch defender of creditors' pre-insolvency rights whilst the other two jurisdictions take a more cautious approach in upholding such rights, with US law giving an active role to the failing debtor to manage its business through the DIP function. The comparative analysis has revealed that when assessing the treatment to be given to close-out netting rights certain value judgements have been clearly based on, or have been influenced by, these national historical developments, but in other instances global developments may have exerted more influence on the legislator.

It is questionable whether the English legislator would have enacted a specific close-out netting law had it not been for the need to transpose the FCD. The transposition itself does not appear to be based on any specific goal, other than to transpose the whole financial collateral regime of the FCD in a way to retain the flexibility already existing under the English regime. Indeed, the conviction that close-out netting already worked under the existing insolvency set-off regime and the fact that the legislator did not feel the need to enact a specific close-out netting regime prior to the FCD make it hard to discern any specific goal which the English legislator intended to achieve with the close-out netting regime it has put in place. The view taken in this research is that since in the end the favourable treatment may be considered congruent with the pre-insolvency contractual entitlements approach already existing under English law and which are given priority ranking similar to real rights, there was no need for a special State insolvency goal to justify the special treatment given to close-out netting.

The French legislator, on the other hand, already had in place a specific close-out netting regime well ahead of the transposition of the FCD. Considering its unfavourable policy on pre-insolvency contractual rights, this early close-out netting regime took on the nature of a loss indemnification mechanism which was initially market-specific, relied exclusively on market rules and established market agreements, and only gradually was made available in situations of insolvency. At the time of the implementation of the FCD the French legislator was open to consider the importation of foreign concepts and to adopt a more liberal approach which would render the French economy more competitive. Thus, for the first time the transposition of the close-out netting provisions gave full recognition to party autonomy and no longer referred to industry bylaws or practices which is typically necessary to establish loss indemnification amounts. Also, the fact that the personal scope has been widened to include agreements on financial instruments concluded between parties one of whom may be a corporate or physical person indicates that the goal may now go beyond that of providing loss indemnification to financial market participants. These changes, coupled with the willingness of the French legislator to take on board other foreign concepts, may serve to indicate that the goal for the basis of this treatment was the openness of the French legislator to innovation in order to enhance the competitiveness of the French markets.

Finally, the US regime has consistently declared the protection against systemic risk as being the goal set for the safe harbours. However, the wide scope of application of its main safe harbour, namely section 560 of the Bankruptcy Code makes it difficult to understand how this can be an overarching goal for the close-out netting protection given under the safe harbours. Whilst the path dependency theory has been put forward by a number of US proponents for the approach taken by the US legislator in enacting the safe harbours, it has been observed that there are instances under BAPCPA and FDICIA where consideration has been given to matters such as the size and volume of business of a counterparty which indicate more clearly the pursuit of the systemic risk goal. The end result is that US law does not in practice follow a single approach in its close-out netting regime so that whilst in the cases of BAPCPA and FDICIA the pursuit of the articulated systemic risk goal is plausible in the circumstances mentioned, in other instances the wide scope of application is perhaps best explained by the external pressure placed on the US legislator to ensure the protection of the derivatives industry.

### 7.3.2 Effect of Resolution Measures

The different State insolvency goals of the three selected jurisdictions may have served to shape the close-out netting regimes currently in place in each of these jurisdictions. The recent financial crisis has brought a shift in thinking about systemic risk and the importance of financial stability. This resulted in the enactment of special resolution regimes mainly for the banking sector which has restricted the exercise of close-out netting rights. The issue to be considered in this part is whether the general pursuit of the financial stability goal has brought an element of convergence in the type of restrictions imposed on the exercise of party autonomy in close-out netting through the resolution regimes of the three selected jurisdictions and the observations made will be used to provide replies in the Preliminary Conclusions to the third sub-question of the Introduction. It is expected that greater similarities will be found between the English and French regimes since both implement the EU's BRRD.[84]

Whilst all three resolution regimes cover banks or important financial institutions in their personal scope, not all regimes make it mandatory to take into account the systemic importance of the institution prior to triggering the resolution regime. English law introduced a banking resolution regime in the Banking Act of 2009, which was later revised to implement the BRRD. The Banking Act regulates the resolution, insolvency and administration of banks and certain investment firms so that these are no longer subject to the provisions of the normal insolvency regime. The French legislator first adopted a resolution law[85] triggered by the FSB Key Attributes and based on a proposal of the draft BRRD so that it already incorporated most of the restrictions affecting close-out netting which are contained in today's BRRD, albeit not with all the details and safeguards provided under the current French banking resolution law.[86] Under French law a bank or investment firm may only be put in resolution if a number of considerations materialise which indicate the systemic importance of that institution. Thus, a determination has to be made in each case to decide whether a particular bank or investment firm is of systemic importance and should therefore be subject to the resolution regime. US law operates different resolution regimes under the FDIA and OLA regimes. The former covers the resolution and liquidation of all credit institutions and replaces the application of the Bankruptcy Code insofar as concerns failing credit institutions. The latter applies to non-bank SIFIs which have been determined as systemically

84 It will be recalled that banks and investment banks falling within the scope of the Single Supervisory Mechanism are governed by the Single Resolution Mechanism Regulation referred to in Chapter 3.2.4.

85 Law No. 2013-672 of 26 July 2013.

86 Ordinance no. 2015-1024 of 20 August 2015, codified in articles L.613-34 *et seq.* of the Financial Code.

important under the OLA regime so that the Bankruptcy Code, including the safe harbours, are only replaced if a determination is made about the systemic importance of the non-bank financial institution. As a result, given that the two regimes may serve to replace the provisions of the Bankruptcy Code, they both reproduce the safeguards for close-out netting provisions envisaged in the safe harbours, save for the restrictions indicated below.

*Ban on Ipso Facto Clauses*

A common concern of all regimes, influenced by the recommendations made in the FSB Key Attributes, is to stop or delay the ability of counterparties to trigger the exercise of the close-out netting provision based solely on the occurrence of a resolution-related event. Thus, all regimes impose a ban or a temporary suspension on the exercise of *ipso facto* clauses triggered by the exercise of one or more resolution measures. Section 48Z of the Banking Act 2009 prohibits resorting to *ipso facto* clauses triggered by the exercise of resolution measures.[87] This provision is not meant to prevent the operation of default clauses which are based on a failure to perform the substantive obligations under the contract or events not directly linked to the application of a crisis prevention measure or crisis management measure. French law, on the other hand, contains a general rule in article L.613-50-3 of the Financial Code that articles L.211-36-1 to L.211-38 of the Financial Code[88] shall not hinder the application of resolution measures. This is a general rule which seems to set a blanket prohibition on the application of, *inter alia*, close-out netting provisions when this could disturb the effectiveness of resolution measures. Construed as it is in vague terms, this may result in wide implications and uncertainty of application. In addition to this general prohibition, French law still contains a number of provisions on the suspension of the exercise of termination rights and set-off rights, amongst other rights, in order to allow specific resolution measures to be exercised, provided always that other essential obligations of the contract continue to be performed. In this respect, article L.613-50-4 of the Financial Code imposes the suspension in relation to the exercise of resolution measures generally, whilst articles L.613-52 and L.613-56-3, III do the same in relation to the issue of transfer orders and to the exercise of the bail-in tool respectively. The FDIA and OLA regimes reinforce the statutory ban on *ipso facto* clauses triggered solely on the grounds of the financial condition of the institution and the appointment of a receiver or conservator, as applicable, and in the former case this ban applies until 5:00 p.m. on the business day

87 Also, in terms of this provision, the Bank of England may provide in any mandatory reduction instrument, share transfer instrument, property transfer instrument or resolution instrument that a default event provision should be disapplied in a particular case even if the general rule does not apply.

88 These provisions transpose the FCD.

following the date of appointment of the receiver.[89] Therefore, contrary to the English and French regimes which impose a ban on *ipso facto* clauses so long as substantive obligations continue to be performed, the FDIA and OLA regimes impose a ban in the case of the appointment of a conservator whose task is to preserve the failing business and a temporary suspension in case of the appointment of a receiver who will ultimately liquidate the business.

*Transfer Orders*

In addition to the general restriction imposed on *ipso facto* clauses, two other common rules specifically targeting close-out netting rights regard the suspension of the exercise of termination rights in relation to the transfer of close-out netting contracts and the prohibition of the partial transfer of close-out netting contracts. Thus, in relation to the first, in all three jurisdictions the resolution regimes provide for the temporary suspension of the exercise of close-out netting rights to allow the resolution authority to transfer all obligations under a contract.[90] Since the English and French regimes are based on the BRRD, almost identical conditions and safeguards are imposed in these jurisdictions to protect, to the extent possible, the close-out netting mechanism. Thus, under these two regimes the resolution authority is empowered to suspend termination rights, defined to include also acceleration, close-out, set-off and netting rights, of any party to a qualifying contract where all obligations under the contract continue to be performed up till midnight of the business day following the day when the instrument provided for the suspension is published and provided the resolution authority does not give notice that the transfer will not take place. The BRRD safeguards apply in the sense that the termination right may be exercised after the expiration of the suspension period if following the transfer of the contract there subsists an event of default which may trigger the termination of the contract. It may be exercised before if the resolution college informs it that the contract will not be transferred or that it will not be subject to recapitalisation measures. Less safeguards appear to be afforded under US law where both FDIA and OLA prohibit the counterparty from terminating, liquidating or netting a qualified financial contract after

89 12 U.S.C. §§1821(e)(10)(B)(i) & (ii), & 5390(c)(10)(B). Under the OLA regime, the restriction applies only in relation to the appointment of a receiver.

90 See Section 70C, Banking Act 2009, article L.613-56-5 of the French Financial Code & 12 U.S.C. §§1821(e)(10)(A)(B) & (ii), & 5390(c)(10)(B). During this period, the obligations of the parties are also suspended.

they receive notice that the contract has been transferred to a third party.[91] It is assumed that these rights may be exercised once the transfer is complete and an event of default occurs in relation to the transferee counterparty. The situation under current US law is similar to that obtaining under English and French law prior to the implementation of the BRRD when a number of safeguards, as mentioned above, were added to protect either the close-out netting mechanism or the effect of the resolution measure on systemic risk.

Second, all three jurisdictions protect against partial transfer orders which serves to ensure that property included under a counterparty's netting arrangement cannot be 'split up' through the exercise of a property partial transfer, which also includes protection of any collateral securing the transactions.[92] Whilst all regimes converge on this point, special reference should be made to the English Banking Act (Restriction of Partial Property Transfers) Order 2009 whereby in case of a contravention of this partial transfer prohibition, articles 10 of the 2009 Order provides that the partial property transfer order is void and article 11 provides that the partial property transfer does not affect the exercise of the right to set off or net. The former provision is intended to provide an administrative remedy in relation to a contravention of article 3 of the 2019 Order.[93]

*Bail-in*

One important key difference between on the one hand the US regime and on the other the English and French regimes which are based on the BRRD, relates to the bail-in tool. OLA and FDIA do not include an explicit bail-in tool because all liabilities are subject to impairment and bail-in to cover losses after closure.[94] For this reason there are no explicit safeguards for the treatment of netting creditors in the case of the exercise of a bail-in tool. There are also significant differences in the exercise of this tool under the English and French regimes.[95] Both regimes provide for the general BRRD rule that liabilities relating to derivatives and financial contracts must be converted into a net debt, claim or obligation before they can be bailed in.

---

91 Citing a number of references, Kounadis states that:

> 'the suspension regime could fulfil its risk mitigation purpose (or be the least disruptive for the smooth functioning of netting) as long as the resolution actions in relation to close-out suspension are subject to certain – clearly spelled out – requirements. It is thus imperative that ability to impose a brief delay on the exercise of early termination and netting rights is subject to certain conditions ensuring appropriate safeguards for close-out netting.'

KOUNADIS (2015) 234. The US regime does not seem to satisfy this expectation.

92 See regulation 3, Banking Act (Restriction of Partial Property Transfers Order 2009, article L.613-57-1 of the French Financial Code & 12 U.S.C. §§1821(e)(9) & (10), & 5390(c)(9)(A).

93 See ISDA 2019 Allen & Overy, 111.

94 For a more detailed explanation of the differences between the exercise of the bail-in tool in the EU and the US, see KRIMMINGER & NIETO (2015) 5.

95 See section 48B, Banking Act 2009 & article 4, Banking Act 2009 (Restriction of Special Bail-in Provision, etc.) Order 2014, & article L.613-55-6 of the French Financial Code.

However, beyond this general rule there are significant differences between the two regimes. Thus, under English law the valuation of the net amount may be done either in accordance with the relevant arrangement specified in the contract or by special bail-in provision which empowers the Bank of England to make an estimate of the net amount.[96] On the other hand, article L.613-55-6 of the French Financial Code provides that the respective obligations owed between the parties must be settled on a net basis as foreseen by the netting arrangements so that the bail-in provision is only exercised on the net amount as originally agreed by the parties. This is contrary to other valuations foreseen in the Financial Code where the normal rule is for this to be calculated by an independent expert.[97] Another important difference is that under English law the special bail-in provision does not foresee the close-out of netting arrangements but solely the determination of a net amount. French law, on the other hand, empowers the resolution college under article L.613-55-6, repeated in article L.613-56-3, of the Financial Code to itself terminate the financial contract to be able to exercise the bail-in provision. Thus, whilst under English law there is continuity of contracts when exercising the bail-in tool, French law has taken the BRRD option to terminate the contracts prior to exercising this tool.

A general safeguard set by the BRRD is that creditors are not treated worse than they would have been in insolvency.[98] This principle has been implemented by the English legislator in Section 60B of the Banking Act 2009 in relation to the bail-in provision. The French legislator, however, has implemented a wider notion of 'no-creditor-worse-off' principle under article L.613-57 of the Financial Code since this principle is generally applicable not only in relation to bail-in but also to transfer orders. In both situations, the redress is by way of compensation and not by reinforcing the close-out netting provision. Although not limited to a particular resolution measure, a limited form of redress is also available under the OLA regime to compensate creditors if they would have received better treatment had their situation been addressed under the Chapter 7 liquidation of the Bankruptcy Code.[99]

*Extent of Convergence*

Given the global nature of the recent financial crisis and the ensuing declarations on resolution measures issued by international bodies such as the FSB, it is to be expected that similar measures were taken by legisla-

96 This may not be consistent with Article 49 of the BRRD which requires the valuation to be done in accordance with the provisions of the netting agreement.

97 See article L.613-47 of the Financial Code. Under the former 2013 resolution regime, the valuation of obligations under derivatives and financial contracts was also based on expert valuation.

98 See Article 34(1)(g) of the BRRD.

99 See 12 U.S.C. §5390(a)(7)(B).

tors to address these resolution concerns. In broad terms, an element of convergence exists in the three types of restrictions imposed on close-out netting identified above, namely the ban or suspension of *ipso facto* clauses, suspension related to transfer orders and the exercise of bail-in, but with substantial variations in the details. English law has imposed a ban on such clauses but leaves open the possibility for the counterparty to trigger close-out netting if a substantive breach of the contract occurs. The French legislator has enacted specific provisions suspending the exercise of close-out netting rights in relation to the various resolution measures. The same safeguard exists that in case of substantive breach, the close-out netting provision again becomes enforceable. US law imposes a ban in case of conservatorship and a suspension in case of receivership but does not offer the same safeguard.

The highest level of convergence has been found to exist in relation to the issue of transfer orders. Two common features regard the imposition of a temporary suspension in order to allow for the effective transfer of contracts and a corresponding safeguard against partial transfers of obligations related to the same close-out netting arrangement. An interesting point is that prior to the BRRD, these rules would have been close to identical in all three jurisdictions. However, following the implementation of the BRRD, a number of safeguards were introduced in the English and French regimes in relation to the suspension which are not reflected in the US regimes.

Arguably the most defining restriction for all the three jurisdictions and the one which mostly sets the level of protection given to party autonomy is that relating to bail-in. Although a type of bail-in exists under US law which takes the form of an impairment of obligations due by the failing debtor, no specific protection for close-out netting exists. Notwithstanding that both implement the BRRD, there are two important differences between the English and French regimes. One difference is more technical and relates to the fact that under French law the contracts need to be terminated by the resolution authority whilst English law foresees the continuity of contracts. More significant is the fact that it is mandatory under French law for the resolution authority to resort to the contractual valuation modality when calculating the net amount of the obligations subjected to the bail-in tool. English law, on the other hand, provides a choice and empowers the resolution authority to estimate a net amount using the special bail-in provision.

All in all, it can be said that the restrictions imposed by the three regimes do have broad similarities, but there are also significant differences which imply different levels of protection to close-out netting provisions. Notwithstanding the general similarity, it is in the details that the greatest contrasts are to be found. For instance, even if it appears that there is a common approach for close-out netting provisions not to affect the exercise of resolution measures, the differences in treatment between imposing a ban or a suspension and whether this is accompanied by a safeguard as aforesaid leaves a great impact on the protection of interests which a close-out netting provision seeks to achieve.

## 7.4 Preliminary Conclusions

A number of conclusions may be drawn from the comparative analysis made in this chapter. First, it has been demonstrated that close-out netting is not simply an economic outcome but is a legal concept regulated on its own right under the law of the three jurisdictions. This was not always the case under English and US laws given that under English law close-out netting initially received recognition under the regime of insolvency set-off whilst under US law it gradually received protection as a contractual right under the safe harbour regime. These issues were gradually addressed through the enactment of specific legislation with the result that today the concept of close-out netting is a comparable one and may be considered as one and the same concept across the three regimes.

Second, the comparative analysis has made it possible to provide replies to the three sub-questions raised in the Introduction. These replies, in turn, should be indicative of the characteristics of the legal systems of the three selected jurisdictions which have shaped the type of recognition given to close-out netting provisions and which will be the principal focus of Chapter 8. Each of the replies will be tackled below.

*First Sub-question*

The influence of set-off rules on the development of close-out netting is mostly present under English law. Close-out netting initially had to satisfy insolvency set-off requirements for its enforceability. Arguably for this reason, its recognition under the FCAR may have not been given the attention it deserves by the legislator with the result that today protection of close-out netting provisions under the FCAR is restricted to those provisions which form part of a financial collateral arrangement. On the other hand, the close association with insolvency set-off may have also influenced the legislator to opt for a wide personal scope to include arrangements concluded between two corporates. In view of this situation, it is arguable that the protection against systemic risk was not even contemplated at the time.

Although close-out netting under French law was built on the existing concepts of termination and set-off, the numerous occasions in which the French legislator has amended and finetuned the close-out netting regime indicates that from an early stage close-out netting developed as a separate stand-alone concept providing compensation against financial loss which was not influenced by set-off requirements. The concept also operates with flexibility which is evidenced, for instance, by the way in which the French legislator applied the FCD opt-out on the scope of application which sees a wider material scope if both parties are eligible entities and a narrower material scope if only one of the parties is an eligible person. The fact that French law extends protection to cases where one of the parties is a corporate or physical person would tend to indicate that the scope behind the French national close-out netting regime goes beyond the protection against systemic risk. The unhindered development of close-out netting was possible due to a number of reasons such as the non-public policy nature of legal set-off, the existence of principles such as the payment of post-insolvency creditors' claims and the general acceptance of exceptions from the *pari passu* treatment of claims.

It is difficult to consider close-out netting under US law as a contractual enhancement of ordinary set-off. Close-out netting appears to have developed as a separate notion under the Bankruptcy Code safe harbours. Indeed, the US legislator created the specific notion of offset to replace set-off under the safe harbours which, although leading to the same economic outcome as ordinary set-off, benefits from the same derogations as close-out netting and is not subject to the restrictions of ordinary set-off. The protection of contractual freedom under the safe harbours was recognised from the start and was based on protection from any stay, avoidance or court and administrative orders issued under the Bankruptcy Code.

*Second Sub-question*

The recognition given to close-out netting provisions under the English FCAR 'in accordance with their terms' is congruent with the favourable treatment under English law of pre-insolvency contractual entitlements. However, one significant limitation is that close-out netting provisions are recognised under this standard only if they fall within the scope of the FCAR, with one of the requirements being that the close-out netting provision forms part, or is related to, a financial collateral arrangement. Close-out netting provisions not falling within the scope of the FCAR continue to be regulated by insolvency set-off rules. Close-out netting under English law (whether falling within the scope of the FCAR or otherwise) is subject to principles relating to the absence of preferential action and of actual or constructive knowledge of insolvency. Although not lacking in controversial debate, the imposition of the observance of these principles may have served to justify the preferential treatment given to close-out netting provisions under the *pari passu* principle. It has been argued in this chapter that on account of its congruence with pre-insolvency contractual entitlements and its compatibility with a number of English law axioms, the recognition of close-out netting under the FCAR does not seem to have been based on any particular State insolvency goal other than the general goal of the preservation of pre-insolvency contractual rights.

The French legislator initially based the recognition of close-out netting clauses on the regulatory and contractual standards set by the markets. It was only upon transposition of the FCD that full contractual freedom in formulating close-out netting provisions was recognised. This transition has led to the proposition made in this research that whilst initially changes to the close-out netting regime were motivated by the State goal of establishing a loss indemnification mechanism for the financial market, the harmonisation of various aspects of the European single market, including that of financial collateral arrangements under the FCD, was considered as an opportunity to focus on the competitiveness of the French market. As a result, French law provides a liberal close-out netting regime that nowadays does not appear to be influenced by insolvency law, given that there is a full and unconditional exemption for close-out netting from the provisions of insolvency law.

The protection of contractual freedom of close-out netting parties under the US safe harbours was from the start based on protection from any stay, avoidance or court and administrative orders issued under the Bankruptcy Code. A step further was achieved by FDICIA which protected close-out netting provisions concluded by market dealers under the 'in accordance with its terms' standard. The protection granted under FDICIA therefore goes beyond that of the Bankruptcy Code. Under both FDICIA and the safe harbours, however, no protection is given from fraudulent acts. Similar to other previously existing safe harbours, the protection given to close-out netting provisions in particular in relation to section 560 of the Bankruptcy Code was based on the goal of protecting against systemic risk. However, the wide definition of swap agreement and the fact that section 560 covered any party to a swap agreement led to the argument that it is difficult to justify the special treatment given under section 560 on this basis. This has led to the debates on the path dependence theory in terms of which each new expansion of the safe harbours was used to justify further expansions. The conclusion reached in this research is that during the period of the enactment of section 560 of the Bankruptcy Code lobbying pressure may have influenced the US legislator to stipulate wide protection for close-out netting in relation to swap agreements to ensure adequate coverage of the newly-emerging derivatives market. However, it has been noted that later expansions relating to BAPCPA and FDICIA, which imposed thresholds to the definitions of financial participant and financial institution, respectively, indicate the taking into account of systemic risk considerations in the formulation of the US close-out netting regime.

*Third Sub-question*

A significant level of convergence has been noted in the resolution regimes of the three selected jurisdictions insofar as concerns the type of restrictions imposed on the exercise of close-out netting rights, especially in relation to the imposition of a temporary stay on the exercise of close-out netting rights. It would thus appear that the global movement, taking the form of declarations by international regulatory bodies and the enactment of regional legal acts such as the EU's BRRD, have influenced this convergence. On account of the implementation of the BRRD, more similarities have resulted in the English and French regimes. However, certain disparities in the detail of these restrictions imposed on the exercise of close-out netting rights have been also noted.

Under English law, restrictions were introduced first in a temporary Banking Act of 2008. At this stage and following the enactment of the original version of the permanent Banking Act of 2009, not many safeguards were included, but the situation was remedied with the implementation of the BRRD. Compared with the other two jurisdictions, English law is not the most favourable in relation to the protection of close-out netting provisions under the resolution regime and this may be due to the fact that certain restrictions applied under the pre-BRRD regime continue to exist under the current regime.

It has been observed that although the French banking resolution regime has imposed some restrictions on the exercise of close-out netting rights in pursuit of the principle of financial stability on account of the implementation of the BRRD, the French legislator took the options which are most favourable to the netting creditor and those which safeguard the terms of the close-out netting provision. In comparison with the other two jurisdictions and consistent with the liberal way in which close-out netting has been protected post-FCD implementation, the French resolution regime may still be considered as having adopted the most liberal and favourable approach in its safeguards to close-out netting provisions.

It is arguably in the US resolution regimes under FDIA and OLA that one sees a more pronounced restrictive approach in the exercise of close-out netting rights when compared with the other two selected jurisdictions. Thus, to provide one instance, the bail-in tool, although existing under US law, does not benefit from the same protections given to the close-out netting provision as under the English and French regimes. When considered together, these US resolution regimes are wider in scope than the applicable resolution regimes of the other two jurisdictions. They also give significant power to the resolution authorities without applying corresponding safeguards to the creditors, including those benefitting from close-out netting arrangements.

Whilst a more detailed elaboration of the influence of the legal systems of the three selected jurisdictions on the recognition of close-out netting provisions will be made in the next chapter, the comparative analysis of this chapter has served to delineate the characteristics of the national close-out netting regimes of the three selected jurisdictions which may not have been possible if each were considered on its own. Although it is typically assumed that close-out netting provisions, especially in master agreements, are best concluded under common law jurisdictions such as English law and New York law, with US federal law regulating the insolvency aspects of it, this assumption may not always be correct since it has emerged that French law, a traditional civil law system, has arguably a more liberal close-out netting regime than the other two jurisdictions.[100]

100 The favourable treatment by French law of creditor rights has been recently confirmed by the choice of French and Irish laws to govern the ISDA master agreement in an attempt to mitigate Brexit risks. See in this respect, DOWNE (2019) 660.