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

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# 8 The Influence of the Legal Systems on the Recognition of Close-out Netting Provisions

## 8.1 Influences on the Development of National Close-out Netting Regimes

The comparative analysis of the laws of the three selected jurisdictions has portrayed both similarities and variances in the way close-out netting has been influenced (or not) by the rules of three particular regimes, namely the set-off, insolvency and resolution regimes. On the basis of the outcome of this comparative analysis, in this final chapter a reply will be given to the main research question on whether the legal systems of England, France and the US have influenced the recognition given to insolvency close-out netting provisions as developed under the *lex mercatoria*. It will be recalled that for the purposes of this research the term *lex mercatoria* has been defined in the Introduction to refer to the influence and standardisation brought about by the declarations of international regulatory bodies, the rules of financial market associations and their standard master agreements which is considered as soft law, capable of exerting moral suasion on national legislators. In the case of England and France, further influence has been exerted by the binding provisions of applicable EU netting law. In addition, a brief description of the historical origins of the civil and common law traditions to which the selected regimes pertain has also been made in the Introduction. The choice to analyse the laws of England, France and the US was justified on the basis that the comparative study of the recognition of close-out netting is more effectively addressed by comparing the close-out netting regimes of jurisdictions that pertain to different legal systems.[1]

It is expected that the philosophy and doctrine of a legal system exerts a significant influence on the development of new law. Micheler is of the view that although the law changes and adapts to new demands and circumstances, change is affected by adapting existing legal concepts, rather than by introducing new legal concepts, in order to avoid legal uncertainty. She considers that even changes related to convergence occur only on the functional level since legal systems continue to use the legal technique most suitable under national law to achieve the desired outcomes.[2] This implies

1 It has been seen in the Introduction that English law follows the common law tradition, French law is a civil law country with its origins in the Napoleonic Code whilst the US has 'evolved a hybrid system of common and legislated laws that is broadly pro-debtor with significant pro-creditor exceptions.' See BERGMAN *et al.* (2004) 6.

2 MICHELER (2006) 50.

that the doctrine and philosophy of the legal systems will perpetuate themselves in new legal developments and this could, as a result, limit the techniques available to a national legal system to respond to the pressure exercised by globalisation.[3]

It is interesting to note the remarks made by Dalhuisen and Goode on the congruence or acceptance of the *lex mercatoria* in common and civil law jurisdictions. Dalhuisen remarks that the *lex mercatoria* in international dealings partakes of the characteristics of common law and this is apparent in the greater reliance on practices, custom and party autonomy, in its operating from case to case, its sensitivity to the facts and in supporting new business structures.[4] On the other hand, Goode notes that the *laissez-faire* approach of the *lex mercatoria* is much less acceptable to civil law jurisdictions where a number of rules particularly in property law are incompatible with modern methods of dealing and finance.[5] Both authors agree that modern states wanting to benefit from globalisation are likely to adjust their regulatory regimes to the *lex mercatoria* in order to create a more level playing field for market players. It may therefore be the case that also modern civil law jurisdictions are amenable to adapt their laws as a response to the needs of international commerce and finance to ensure that their legal systems remain competitive.

It is proposed to deal with the main research question in the following way. First, the original and current role played by set-off in the three selected jurisdictions will be analysed. Set-off achieves the same economic result as close-out netting and may shed light on whether precepts which influenced the development of set-off have also played a role in the recognition of close-out netting. Second, it will be considered whether the development of close-out netting has occurred in a way which rendered this concept congruent with the rationale and principles of national insolvency law or whether it developed in a way which transcends the precepts of insolvency law and follows different state goals. Third, the EU's FCD sets standards on the recognition of close-out netting provisions which were implemented by the EU Member States. It will be considered whether in the case of English and French laws these standards may have influenced a deviation from the traditional approach taken by the legal systems to which they pertain or whether the implementation of the FCD was carried out predominantly under the influence of these legal systems. Finally, the financial crisis of 2007-2009 brought about a series of recommendations from international regulatory bodies which was followed by the adoption of resolution regimes globally to address failing banks. These resolution regimes have

3 Dalhuisen considers that the inclination for legislators to lean on the comfort of the established framework is an inhibiting factor in the development of a *lex mercatoria*, and this despite the fact that national frameworks do not cope well with international transactions. DALHUISEN (2015) 59.

4 DALHUISEN (2019), Volume 1, 29.

5 GOODE (2005) 541.

restricted the exercise of close-out netting rights. For EU Member States, these limitations have been set by the BRRD. In this final part it will be examined whether there is a common trend in the limitation of close-out netting rights which may have been influenced by these international developments or whether the influence of the legal systems continues to dominate even in the implementation of bank resolution regimes.

## 8.2 The Role and Development of Set-off Within the Legal Systems

The relationship between set-off and close-out netting has already been discussed in the national chapters principally from two perspectives, namely whether close-out netting may be considered as a contractual enhancement of the concept of set-off and what is the role, if any, still played by set-off under the close-out netting mechanism. The contractual enhancement aspect was further considered in the comparative analysis of Chapter 7.2.1 where it was generally concluded that in relation to the three selected jurisdictions close-out netting can be considered as an independent concept which does not, strictly speaking, depend on the observance of set-off rules for its enforceability. This part will briefly consider the role fulfilled by legal or insolvency set-off within the legal system of the three selected jurisdictions. Whilst the historical origins of set-off under Roman law and its introduction in the three selected jurisdictions were discussed in Chapter 1.2.1, this part will identify its original and current function, and delineate any fairness, moral or efficiency considerations which influenced its development. Given the close affinity of the concepts of set-off and close-out netting and the similar economic outcome that they achieve, this review is to serve as one of the bases in this chapter for considering whether the same or similar influence of the legal systems which has served to shape set-off can still be traced in the development of close-out netting.

*English Law*

It has been seen in Chapter 1.2.1 that set-off was originally met with resistance in England, mostly due to the formalistic pleading procedure at the time (which did not allow for collateral issues to be taken into consideration) but was gradually considered favourably on account of its equitable treatment features. In fact, the first historical role given to set-off by statute in 1705[6] was that of a defence for the alleviation of the hardship of bankrupt prisoners. Later, the 1729 statue[7] established a general right to set-off under common law intended to avoid the imprisonment of debtors who could not pay their debt when they had a counterclaim arising out of the same

6 Act of 4 Anne (1705).
7 Act for the Relief of Debtors with respect to the Imprisonment of their Persons (1729) 2 Geo. II.

transaction. The Debtors Relief Amendment Act of 1735[8] confirmed and extended the 1729 statute to cover mutual debts deemed by law to be of a different nature. According to Pichonnaz, the aim of these statutes was not only to avoid multiple actions in justice but also to render common law more in conformity with the equity required by natural justice.[9] McCracken considers that the notions of justice and fairness behind the statutory recognition of set-off in insolvency in the 1705 statute to be narrow insofar it was confined to the interests of debtor and creditor, making no reference to the interests of third parties.[10] Of the same view is McCoid who attributes the thinking at the time to the situation that the bankruptcy trustee was considered as successor to the debtor's interests in property, rather than as a representative of creditors.[11]

Under current English law the role of insolvency set-off is no longer to avoid multiplicity of actions but rather to ensure material justice between the parties and has therefore taken on a more substantive role. Its rules have become mandatory and parties may not derogate therefrom. The debate on its moral justification continues. In *Forster v Wilson*[12] the court held that the policy behind the mandatory nature of insolvency set-off is to rectify the perceived injustice of a debtor of an insolvent who is also the insolvent's creditor having to pay the full amount of their liability to the insolvent, whilst receiving only a reduced dividend on its cross-claim. Peck *et al.* criticise this traditional justification for insolvency set-off and contrast the situation with that of equitable set-off outside insolvency, which is available only where the cross-claims are so closely connected that it would be manifestly unjust to allow one of them to be liquidated without taking the other into account. They conclude that to the extent that insolvency set-off goes beyond this requirement, it cannot be justified by reference to fairness.[13] To these arguments Derham adds that the right of set-off operates irrespective of whether the set-off was actually relied on by the parties when entering into the transaction or whether it was acquired coincidentally by a third party through assignment. In the latter case, he considers that the justification arguments brought in favour of insolvency set-off may not carry the same weight.[14] Various arguments may be brought in relation to the repercussions of insolvency set-off on the application of the *pari passu* principle, mainly that it allows the solvent party to collect payment ahead of other creditors to the extent of the set-off and thus fewer assets will be left for distribution among general unsecured creditors. All in all, however, the

8 Act for the Relief of Debtors with respect to the Imprisonment of their Persons (1735) 8 Geo. II.
9 PICHONNAZ (2001) 574.
10 McCRACKEN (2010) 51.
11 McCOID (1989) 21.
12 [1843] 12 M&W 191.
13 PECK *et al.* (2011) 5.
14 DERHAM (2010) 245.

general view under English doctrine is arguably that insolvency set-off is an equitable concept which is compatible with the protection of pre-insolvency entitlements typically protected in common law jurisdictions.

*French Law*

It has been seen in Chapter 1.2 that the development of set-off under French law has been influenced by the rules on *compensatio* found in Justinian's Code. Writing at the time preceding the drafting of the Napoleonic Code, Pothier considered set-off as a form of payment or extinguishment of debts and which therefore had to partake of the strict requirements of payment. Thus, the two debts had to be due between the same persons and in the same right, be in the same coin, fully due and liquidated. Pothier concluded that set-off was automatic on the basis of the interpretation of the words '*ipso iure*' in Justinian's Code.[15] Pothier's teaching formed the basis of the Napoleonic Code's articles on set-off. Pichonnaz notes that whilst the Napoleonic Code was very clear that set-off is automatic and is effective even against the will of the parties, it was not long before French authors would argue that set-off had to be pleaded in court as a matter of practicality and the existence of the debt had to be proved in order for the judge to take it into account. Being a means of extinguishment of debts, it could also be raised at any stage of the proceedings and if not raised the creditor was considered to have renounced to its right for compensation.[16] Contrary to English law therefore, set-off under French law was from inception regarded as a substantive matter, rather than a procedural tool, since it was deemed effective from the moment when set-off requirements had been met.

Notwithstanding the changes to the set-off regime of 2016, the new articles 1347 to 1348 of the Civil Code replacing the former articles 1289 to 1299 still place set-off under the heading of Extinguishment of Obligations so that set-off is still considered as a simplified means of payment. In addition to the statutory recognition of three types of set-off, namely legal, judicial and contractual, the current French Civil Code has imposed under article 1347 the requirement that set-off is invoked. This new requirement has generated discussion on its interpretation, as seen in Chapter 5.2.1, but typical of civil law jurisdictions this has not led to a debate on fairness considerations. This arguably reflects the civil law idea that the law is what the legislator says it is and value considerations are not given paramount importance. On the other hand, whilst French law does not distinguish between the types of set-off in an insolvency situation so that each type may be rendered applicable, it does provide in article L.622-7, I of the Commer-

15 Pothier, *Traité des obligations* §§ 624, 626, in 2 Oeuvres 1 (Bugnet ed. 1861), cited by TIGAR (1965) 246.

16 PICHONNAZ (2001) 512.

cial Code that set-off of pre-insolvency claims is exempted from insolvency law observation periods only in respect of connected claims[17] and provided these have been declared in terms of article L.622-24 of the Commercial Code. In the reasoning of Peck *et al.* cited in the part dealing with English law, this solution appears to be more just in relation to the preference given to the set-off creditor than the notion of insolvency set-off under English law which gives the parties considerable flexibility, including the possibility of setting off a claim following an assignment so that claims being set-off are not necessarily connected, though they must be mutually owed. Similar to English law, payments of matured debts performed after the date on which a company becomes insolvent are voidable if the beneficiary had actual knowledge of the company's insolvency.[18]

Although set-off under French law retains the original purpose of a simplified means of payment, it is not easy to establish if its nature has changed with the new invocation requirement. In its origins, French set-off law of the Napoleonic Code of 1804 was based on the interpretation of Justinian's Code that set-off operated automatically (*ipso iure*), even against the knowledge of the parties. Later, in an 1880s law,[19] set-off was held not to be a matter of public policy and it could be renounced by the parties. This could be due, at least partly, to the fact that the function of set-off is that of a simplified means of payment and hence is not primarily linked to the fulfilment of an equitable purpose. In relation to judicial proceedings, a consistent line of doctrine developed stating that set-off has to be invoked to enable the judge to take cognisance of it. This notwithstanding the former article 1290 of the Civil Code providing that set-off takes place automatically, even against the will of the parties. A consequence of this doctrine is that the non-invocation of set-off was interpreted to imply that the creditor was renouncing its right of set-off. With the recent changes to the Civil Code, set-off must be invoked in order to be effective so that the renunciation element has been replaced by a suspensive condition to invoke the set-off which is then made effective retroactively from the date when all conditions for set-off have been fulfilled. Hence, what started as a procedural requirement that the creditor raises the plea of set-off in judicial proceedings, has now become a substantive mechanism dependent on the will of the parties. But in any case, set-off was, at least since the 1880s law, already dependent on the will of the parties, either because it could be renounced or, under current law, because it needs to be invoked.

17 See article L.622-7, I of the Commercial Code. It has been seen in Chapter 5.2.1 that the French courts have stated that claims are connected when they result from the same contract or when carried out pursuant to different contracts which constitute a single global business relationship agreement.

18 See article L.632-2 of the Commercial Code.

19 Req. 11 mai 1880.

*US Law*

Regulation of set-off in the US predates the English statutes since as early as 1645 the colony of Virginia and Maryland permitted the set-off or discounting of debts. Based on notions of fairness, all bankruptcy statutes beginning with the Bankruptcy Act of 1800[20] have provided for the set-off of mutual debts and credits. Similar to English law, under US law set-off began as an innovative pleading tool raised in defence to a claim in court and was based on natural justice considerations. With the advent of the liberal pleading rules embodied in the Federal Rules of Civil Procedure, much of the original purpose and procedural complexities of set-off disappeared. As a result, set-off now operates also outside of judicial proceedings and, although still subject to court intervention at times, has become a widely recognised area of substantive law.[21]

The US courts played a significant role in the development of set-off, particularly in the initial stages. It has been seen in Chapter 6.2.1 that the US courts were initially reluctant to allow set-off in reorganisation cases since this was deemed to go against the principle of a fair and proportionate distribution to creditors and advocated a case-by-case assessment of the situation intended to give the debtor or the trustee the opportunity to propose a reorganisation plan. By the time of the promulgation of the Bankruptcy Reform Act of 1987, the general approach taken by the courts was that set-off is a fair and equitable process to satisfy creditors' claims and, subject to some court intervention, is generally enforceable. Most courts now permit set-off absent 'compelling circumstances' and treat it essentially as a security interest, rather than as the equitable remedy of its origin.[22] The security justification became entrenched in the Bankruptcy Code of 1978 whereby section 506(a) declares that, similar to a claim secured by a lien, a claim subject to set-off under section 553 of the Bankruptcy Code is secured.

Under US law, set-off is primarily regulated by State law, which rules are pre-empted by the provisions of section 553(a) of the Bankruptcy Code upon the bankruptcy of the debtor. It is generally a voluntary act which requires invocation by the creditor and whose enforcement lies within the discretion of the bankruptcy court. Perhaps more than the other two jurisdictions, the intervention of the courts is typically resorted to under US law in case the basic requirements of set-off, in particular those relating to maturity and liquidity, cannot be met. As a general rule, the Bankruptcy Code still subjects the exercise of set-off to the general principles of the automatic stay, the prohibition of creditor preferences and the prohibition of fraudulent transfers. Hence, the principle of maximisation of the value of the bankrupt's estate is foremost in the mind of the legislator. However, certain inroads have been made into the strict application of these principles

20 The Bankruptcy Act of 1800, ch. 19, § 42, 2 Stat. 19, 33 (repealed 1803).
21 SEPINUCK (1988) 54.
22 SEPINUCK (1988) 57.

by the aforementioned section 553(a) of the Bankruptcy Code, giving rise to some exceptions which seek to allow the exercise of set-off where this was considered justified. Thus, in relation to the automatic stay, section 553 of the Bankruptcy Code protects the set-off of mutual debts that arose before the commencement of the bankruptcy proceedings, whilst court approval is required to implement a right of set-off in relation to claims that arise after the commencement of bankruptcy proceedings. This gives the opportunity to the court to appreciate whether set-off is merited in these circumstances. In relation to the prohibition of creditor preferences, the enforcement of set-off is generally restricted by the ninety-day observation period.[23] In relation to the prohibition of fraudulent transfers, if an obligation of the debtor is the result of a fraudulent transfer, the bankruptcy trustee, acting under powers granted to it by section 548 of the Bankruptcy Code, may avoid that obligation and so it would not be available for set off against any debts owed to the debtor. US law therefore permits few exceptions in favour of set-off from the application of US bankruptcy law principles.

*Distinctive Tendencies of the Legal Systems*

The above analysis has sought to give an overview of the scope and development of set-off in the three selected jurisdictions in order to trace tendencies of the applicable legal systems.

From its inception set-off under English law was a procedural mechanism intended to facilitate relations between parties and was based on equitable grounds but took into account principally the interests of the parties to the transaction, rather than the general body of unsecured creditors. The foundation on which set-off was built served to consolidate the role of set-off into a more substantive one and led to the creation of the notion of insolvency set-off which is mandatory and self-executing. It may be difficult to understand why the legislator chose to render the concept mandatory rather than provide a mechanism of 'self-help', especially since various authors have expressed views that set-off under English law operates also as a kind of security, which is typically voluntary in nature. Also, given the flexibility with which the concept operates without the need for court intervention and given that there is no strict connexity required for claims to be set off upon insolvency, it is difficult to reconcile this notion with its self-executing nature, its equitable foundation and the insolvency state goal of business rescue entrenched in the Enterprise Act of 2002. On the other hand, it is easy to categorise the rights derived from set-off as a type of pre-insolvency contractual entitlement under English law which constitutes a statutory exception to the *pari passu* principle and is evident of the pro-creditor tendency of the English insolvency set-off regime.

23 See Sections 553(a)(2)(3) & 553(b) of the Bankruptcy Code.

Typical of civil law countries in Western Europe, the origins of set-off under French law were heavily influenced by Roman law. Given Pothier's interpretation of the Justinian's rules of *compensatio*, set-off was rendered automatic under the Napoleonic Code. The nature given to set-off is thus the result of the technical interpretation of the words '*ipso iure*' used in the Justinian Code and nowhere does it appear to have been based on considerations of fairness and morality. Notwithstanding its automaticity, set-off could, since its early stages, be renounced by the parties and at law it was not considered to be a matter of public policy. This state of affairs may be explained by the fact that the role given to set-off under French law was a functional, rather than a moral, one. Set-off was in fact considered as one type of mechanism to extinguish debts (and hence was always a substantive matter), and the initial strict basic requirements which needed to be fulfilled and its automatic nature were deemed compatible with set-off being a means of payment. Set-off is today still considered as a simplified means of payment. Set-off was from the beginning a voluntary act, considering that the possibility to renounce to set-off has now been replaced by the need to invoke it. Once invoked, it produces retroactive effect from the moment when its basic requirements have been fulfilled. Due in large part to its nature as a means of payment, the French legislator did not deem it necessary to create the notion of insolvency set-off but instead the existing types of set-off continue to be regulated by the normal insolvency law principles, save where exceptions are permitted by law. The two principal exceptions are that pre-insolvency claims should be connected and post-insolvency claims will be set off if required for the purpose of the proceedings, subject to the discretion of the courts. It is difficult to make a categorical statement that the regulation of set-off under French law adopts a pro-debtor approach. In its fundamental aspects, it may be stated to be pro-debtor mainly for the reasons that it is not mandatory and self-executing, it does not benefit from a pre-insolvency entitlement privilege regime and it is subjected to the insolvency law principles, save where otherwise permitted. On the other hand, certain pro-creditor traits can also be detected, the main one possibly being that the exceptions from the application of the insolvency law principles apply to all three types of set-off recognised under French law, namely legal, judicial and contractual, which implies that as long as there is mutuality and connexity, contractual arrangements on set-off will be enforced upon insolvency. This renders the set-off regime under French law more advantageous than the English regime at least in one important aspect, namely that under contractual set-off it is even possible for parties to convert by agreement non-monetary obligations such as delivery obligations into monetary ones.

The beginnings of set-off under US law were similar to those of English law set-off. Thus, set-off developed as a defence and a pleading tool in court based on equity considerations and obtained a more substantive role once it became more widely established. It is also considered as a form of security. Notwithstanding these similarities with English set-off law, the US set-off regime is in doctrine considered to be pro-debtor with a few pro-creditor exceptions. Similar to the French regime, the US set-off regime is, depending on the applicable state law, a voluntary act and has to be invoked. There is greater reliance on court intervention than in the other two jurisdictions for the fulfilment of its basic requirements when these have not been fully met. Set-off continues to be regulated by the insolvency law principles of the Bankruptcy Code save for exceptions permitted by section 553 of the Code. Claims arising between the parties prior to the ninety days' period which are not considered as fraudulent conveyances are generally permitted to be set off upon bankruptcy, but other claims remain subject to the ninety-days' observation period rule and may require court intervention to be set off. Set-off under US law therefore partakes of the substantive nature of set-off under English law, needs to be invoked as under French law but its unique feature is the extent of court intervention still required to permit its enforceability upon insolvency. Overall, US insolvency set-off law may be considered as the most pro-debtor of the three selected jurisdictions.

## 8.3 Tracing the Link between Set-off, Close-out Netting and Legal Systems

A general assumption was made in Chapter 1.2 that close-out netting is typically based on national pre-existing legal concepts which have been combined, adapted and enhanced to serve the needs of the financial markets. This research has focused on the concept of set-off as forming the basis for the contractual enhancement aspects of close-out netting. Other concepts have also been mentioned as playing a role, albeit a more restricted one, such as the account current and novation. The common aspect of these concepts is the ability to reduce the exposures of the parties to one single amount. For this effect to be achieved, a number of basic requirements need to be fulfilled, such as the reciprocity of the amounts owed. It has been seen in relation to set-off that an element of flexibility may apply under national law in the fulfilment of these basic requirements. The general trend is for the contractual enhancement aspects of close-out netting to go beyond this flexibility allowed by national insolvency set-off law. In this part it will be analysed whether these contractual enhancements as they relate to party autonomy still follow the characteristics and tendencies of the legal systems to which they relate, namely those of England, France and the US. The influence of the legal systems on the development of close-out netting will take into account both the scope and development of close-out netting in the three selected jurisdictions, other general precepts and legal doctrine of the applicable legal system as well as its congruence with insolvency law and state insolvency goals.

## 8.3.1 English Law

In Chapter 4.2 two phases in the development of close-out netting under English law have been noted. Initially, close-out netting was given effect under the mandatory provisions of insolvency set-off as evidenced by the 1993 Guidance Notice on Netting of Counterparty Exposure issued by the Financial Law Panel. As a result, close-out netting provisions had to be drafted in a way which abided by insolvency set-off rules.[24] At a second stage, with the enactment of the FCAR in 2003 close-out netting provisions forming part of a financial collateral arrangement as defined by those Regulations were recognised under the standard 'in accordance with its terms' and it was no longer necessary to adhere to insolvency set-off rules for their validity. The FCAR regime implements the EU's FCD which is principally concerned with the harmonisation of financial collateral across the EU. It is on the basis of the FCAR that an analysis will be made of the influence exerted by the English legal system on the recognition given to close-out netting provisions.

### *8.3.1.1 Relationship with Set-off*

Close-out netting provisions regulated by the FCAR have been given recognition without the necessity that these adhere to the mandatory insolvency set-off rules. This state of affairs raises two observations. First, notwithstanding that insolvency set-off replaces other forms of set-off including contractual set-off, it does not seem to replace insolvency close-out netting. This could result from the fact that English common law recognises the development of concepts under non-statutory sources, such as party autonomy, so that the rules on insolvency set-off affected only part of the concept of close-out netting. It also reflects the situation that insolvency set-off may only be exercised in respect of executed contracts and it does not, technically speaking, involve any termination of transactions, the overlap with close-out netting lies only in the third phase of netting so that it is not the whole concept which is subjected to the insolvency set-off rules as otherwise there is no possibility to exercise the termination and valuation phases according to the terms of close-out netting provisions.

Second, the question arises whether close-out netting which used to be, or still is, regulated by the rules on insolvency set-off also shares the same role and justification for its foundation. In this research, close-out netting has been considered as an independent concept separate from insolvency set-off but which, prior to the enactment of the FCAR, relied on the mandatory rules of insolvency set-off for its enforceability. Insolvency set-off developed out of the need to maintain fairness between the parties and is today considered a type of security to the parties for the discharge of

24 YEOWART *et al.* (2016) 228.

obligations, at least up to the lesser amount due. The fulfilment of its basic requirements is considerably flexible. Thus, for instance, whilst reciprocity of claims is an essential requirement, legal doctrine recognises that it may be satisfied through intra-group guarantees and third-party assignment of debts, which arrangements are not readily recognised under the other two selected jurisdictions, at least without court intervention. It cannot be said with certainty that prior to the FCAR close-out netting performed the same role and developed on the same equitable basis as set-off, although it shared the same legal basis. It has been seen earlier in this chapter that the main policy justification for set-off under English law is that mutual credit has been given by the parties on the basis of the understanding that these could be set off against each other, so that one credit serves as security for the other. Close-out netting was from inception a risk mitigation tool created by the financial market on the basis of party autonomy and, in the absence of *ad hoc* statutory recognition, relied on the flexible rules of insolvency set-off for its enforceability. Such a situation would probably not have been possible in a civil law country where contracts rely on statutory fiat for their validity, but it is arguably possible in a common law jurisdiction where external sources such as party autonomy may be taken into account for the operation of contractual arrangements as long as they do not breach mandatory law. The mandatory law in this case relates to insolvency set-off which operates with sufficient flexibility to permit the operation of most close-out netting provisions though not without an element of uncertainty as to the extent of their enforceability. For a significant period of time therefore the English financial market players were operating the concept of close-out netting with this uncertainty which may have led the Financial Law Panel to issue the Guidance Note on the Netting of Counterparty Exposure in 1993 and, to a limited extent, fulfil the task which should have been the legislator's, *i.e.* to provide certainty on the enforceability of close-out netting provisions at a time when the derivatives market was gaining importance and England did not have its own netting legislation. It is indeed surprising that the English legislator did not take the opportunity of providing more certainty by enacting netting legislation but waited until 2003, when the UK was obliged to transpose the provisions of the EU's FCD, to do so.

#### *8.3.1.2 Scope of Application*

The adoption of the FCAR in 2003 solved a number of uncertainties concerning the enforcement of close-out netting provisions. It will be recalled that since the main scope of the FCAR is to transpose the provisions of the FCD, it is primarily a law regulating the harmonisation of financial collateral arrangements so that the provisions on the recognition of close-out netting provisions operate within this context. For this reason, certain options taken by the legislator, such as the scope of application of the Regulations, were taken foremost with the regulation of financial collateral arrangements in mind. One such instance is that the protection given to close-out netting provisions relates only to those provisions which form part of a financial collateral arrangement. Although this is sufficiently widely framed and should cover master agreements typically entered into by the financial community, it has created the situation whereby those close-out netting provisions not covered by the FCAR continue to be subject to the uncertainty created by the mandatory rules of insolvency set-off, as was the case for all close-out netting provisions prior to the enactment of the FCAR.

It is doubtful whether this was the intention of the legislator, *i.e.* to create two different close-out netting regimes, or whether this was the inadvertent consequence of the faithful implementation of the FCD. The view expressed in this research is that the existence of two regimes is the consequence of the faithful implementation of the FCD whereby certain implementation decisions were taken on the basis of the general scope of the FCD, namely the regulation of financial collateral arrangements. Thus, the opening statement of the FCAR consultation document on the implementation of the FCD focuses only on the establishment of a financial collateral arrangement regime and states that the approach taken in implementing the FCD: '[…] is to extend the scope and usefulness of financial collateral arrangements as widely as possible having regard to general UK policy on insolvency.'[25] This is also the case in relation to the personal scope of the FCAR which was extended to cover arrangements between two corporate entities as this was considered consistent with the overall policy objectives in UK law 'where many of the Directive's provisions already apply *irrespective* of the identity/capacity of the parties[…].'[26] Thus, the rationale for a wide personal scope of the FCAR does not seem to take into account the risk mitigation role played by close-out netting provisions, nor the effects arising from the privileged ranking granted to the netting creditor.[27] This state of affairs leads to the difficulty in defining the role and justification which the legislator intended to give specifically to the recognition of the close-out netting concept and in gauging the influence of insolvency set-off on the development of close-out netting under the FCAR.

#### *8.3.1.3 Recognition 'In Accordance With Its Terms'*

The implementation of the close-out netting provisions of the FCD was clearly influenced by the conviction that close-out netting provisions were already enforceable under English law. The FCAR consultation document provides that although there are no insolvency law provisions which need to be disapplied in order to give effect to Article 7(1) of the FCD, the

25 HM TREASURY 2003 FCAR Consultation Document, para 1.12.

26 *Ibid.* paras 2.2 and 2.3.

27 This view does not seem to be shared by the court in the *Cukurova* case already considered in Chapter 4.1 where it was held *obiter* that the wider the scope of the FCAR, the better the protection against systemic risk.

proposed FCAR includes a provision that close-out netting provisions are to take effect in accordance with their terms so as 'to deal with any doubts there may be about the effectiveness of such terms when a company becomes insolvent due to common law or equitable principles which could be used to undermine close-out netting provisions.'[28] This statement reveals two aspects of the intention of the legislator. The first is that consistent with the 1993 Financial Panel Statement, the legislator appears to be convinced that close-out netting provisions can be enforced in an insolvency situation, presumably under the rules of insolvency set-off, without the need for specific statutory recognition. Second, the legislator is also aware that limitations set by the same insolvency set-off rules was creating uncertainty in the enforcement of close-out netting provisions. Thus, it could not be certain if the courts would invalidate a close-out netting provision that went beyond the scope of the insolvency set-off rules on the basis that the parties were trying to contract out of the insolvency rules.[29] There is therefore the dichotomy under English law that the legislator considers close-out netting provisions were already enforceable under English insolvency law whereas English doctrine was concerned about the uncertainties of their enforceability. Rather than resolve these uncertainties by granting recognition to close-out netting provisions generally, the legislator chose to faithfully implement the material scope of the FCD and apply it to close-out netting provisions so that the implementation of Article 7(1) of the FCD which recognises close-out netting provisions in accordance with their terms, does so only in relation to those provisions which form part of a financial collateral arrangement or are related to it.

Other than for the wider personal scope, the FCAR faithfully reproduces the provisions of the FCD. In these circumstances, the question arises on how is it possible to trace the influence of common law in the development of close-out netting under English law? The answer lies mostly in the details of implementation. Regulation 12 of the FCAR which recognises the principle of party autonomy in close-out netting provisions is very detailed in its provisions, which is typical of the style of drafting of common law jurisdictions. The interpretation ambiguity associated with regulation 12 has already been dealt with in Chapter 4.3. It is also recalled that regulation 12 applies only to close-out netting provisions when winding-up proceedings or reorganisation measures are pending against one of the parties and these exclude resolution measures under the Banking Act.

The list of exceptions to the recognition of party autonomy enunciated in regulation 12(2) of the FCAR is 'homegrown' and is reminiscent of the exceptions provided in rule 14.25(6) of the Insolvency Rules 2016 which prohibit the setting off of claims when the solvent party had actual knowledge of the pending insolvency. This indicates both the influence which

28 HM TREASURY 2003 FCAR Consultation Document, para 5.9.

29 This discussion has been raised in Chapter 7.2.1.

set-off rules still exert over the development of close-out netting as well as the assimilation of rights and privileges associated with both set-off and close-out netting mechanisms. It is arguably for this reason that the legislator felt the need to balance the exercise of close-out netting rights with an obligation that the solvent party *should not be aware* of the commencement of insolvency proceedings. But the legislator went beyond in the case of close-out netting and imposed the obligation that the party *could not have been aware* that winding-up proceedings or reorganisation measures had been commenced against the other party. Although the notion of constructive knowledge is familiar to English legal doctrine, it has not been made applicable in relation to insolvency set-off. The condition of constructive knowledge is imposed by the FCD in its Article 8(2) in cases where the financial collateral obligation came into existence on the same day but after the moment of opening of insolvency proceedings. The English legislator has therefore taken a stricter approach towards the general recognition of close-out netting provisions than exists under both the FCD and the English rules on insolvency set-off which is arguably an indication of a new more equitable balance that the legislator is seeking to strike for the exercise of close-out netting rights.

Whilst regulation 12(2) imposes a number of conditions restricting the enforceability of close-out netting provisions, regulation 12(4) and other provisions of the FCAR seek to exempt the recognition of close-out netting provisions from the operation of specific provisions of insolvency law. Thus, rather than providing for a general derogation from the provisions of insolvency law as this was deemed not to be required for the enforceability of close-out netting provisions, the legislator opted to provide for specific derogations where uncertainties may have existed. The legislator is thus working on the assumption that close-out netting is generally enforceable and has sought to exclude those provisions of insolvency law giving rise to doubts as to its enforceability. In this respect, regulation 10(1) provides an exemption from section 127 of the Insolvency Act 1986 in relation to avoidance of property dispositions. Regulation 12(4) provides an exemption from certain provisions on insolvency set-off of the Insolvency Rules. Finally, regulation 14 provides modification rules for the conversion of currency under the Insolvency Rules.

This evidences a virtual break from the influence of insolvency set-off rules mainly in two ways. First the legislator did not deem it necessary to state that insolvency set-off rules in general do not apply since henceforth close-out netting provisions are enforceable in accordance with their terms. Second, where uncertainties remain such as in the conversion of foreign currency, specific modifications or exclusions were introduced. However, it has also been seen that some influence remains in the morality justification of close-out netting rights which, like set-off rights, bestow privileged rights to the creditor. For this reason, the legislator has imposed similar conditionality for the recognition of close-out netting rights relating to the lack of knowledge of the pending insolvency.

### *8.3.1.4 Congruence with State Insolvency Goals*

In Chapter 4.4 it was recognised that the privileges associated with the exercise of close-out netting rights could be classified as a type of pre-insolvency contractual entitlement which is favoured by English common law. Similar to the protection of the privileges derived under insolvency set-off which are recognised by statute, the exercise of close-out netting rights under the FCAR cannot be stated to breach the *pari passu* principle and they are not considered a means of contracting out of insolvency law. However, it is not so straightforward to equate the privileges enjoyed by the party benefiting from close-out netting rights with those derived from insolvency set-off. Insolvency set-off, although operating with significant flexibility, is limited by statute in the fulfilment of its basic requirements and is generally enforceable subject to insolvency procedural law such as the requirement of the proof of claims. The ultimate justification for the enforceability of close-out netting provisions under the party autonomy principle is that the size of the parties and the extent of interconnectedness and exposure they have with each other merits the privilege given to the solvent party to close out and net its whole business relationship with its insolvent counterparty to avoid systemic risk. It is thus not only an asset of the insolvent estate which the unsecured creditors are being deprived of as in the case of insolvency set-off and even in the case of secured credit, but the whole insolvent estate could be significantly depleted on account of the exercise of close-out netting rights. As noted by Henderson in Chapter 4.2.2, the whole relationship of the two parties is privileged in a close-out netting arrangement, including any cross-product netting arrangements, and not just a single transaction. This effect is mainly brought about by the possibility given to the solvent party to terminate or accelerate all outstanding transactions on the sole basis that insolvency has occurred. As a result, the classification of close-out netting rights as a type of pre-insolvency contractual entitlement must be considered in the light of the wider implications this type of entitlement may have on the insolvent estate.

In sum, two main influences have been detected in the development of close-out netting under the FCAR. The first is the close association with insolvency set-off whereby similar conditionality for the exercise of close-out netting rights has been imposed, namely related to the lack of knowledge of the pending insolvency. This could indicate that close-out netting, like insolvency set-off, is also based on morality considerations. The second is the focus of the English legislator when transposing the FCD on the implementation of a liberal financial collateral regime which was widely drafted to render the London financial market more competitive globally.[30]

30 HM TREASURY 2003 FCAR Consultation Document, para 1.12.

As a result, the same scope of application for the financial collateral regime applies also to close-out netting provisions. Given that this scope of application includes agreements concluded between any two corporates, irrespective of considerations of systemic importance, it may be difficult to reconcile the development of close-out netting with a particular state insolvency goal other than the one pertaining to the English financial collateral regime, *i.e.* the competitiveness of London as a financial centre.

### 8.3.2 French Law

The close association under French law between close-out netting and the concepts of termination and set-off is evident in the terminology often used in doctrine to refer to the concept of close-out netting, *i.e.* '*résiliation-compensation*'. It does not appear debatable for French authors that close-out netting is indeed based on these two concepts. Thus, it has been noted in Chapter 5.2 that according to Roussille whilst the legislator had a choice to either create a *sui generis* mechanism or to adapt existing legal mechanisms, the legislator took the latter route by associating two mechanisms, namely termination and set-off allowing the counterparties to terminate operations in the case of a risk of insolvency and setting off amounts due to achieve a net sum payable.[31]

Notwithstanding the close association with the concepts of termination and set-off, contrary to English law the development of close-out netting under French law occurred from inception under *ad hoc* netting law. The close-out netting mechanism under the earlier netting laws consisted of two parts. First, the law permitted the setting off of financial obligations under the modalities of valuation set in the contract provided these were in line with the rules of relevant financial market associations or the terms of the national or international master agreements in place for that market. Second, termination of the transactions was only permitted in case of the insolvency of one of the parties. This was the case under the law of 1987[32] in relation to the securities lending market, the law of 1993[33] on the futures market and all relative amendments to the netting laws until the implementation of the FCD in 2005. Following the 2005 amendments,[34] the former article L.431-7 of the Financial Code referred equally to termination and set-off as the two elements comprised in the enforceability of close-out netting provisions whether within or outside of an insolvency situation. Thus, although it is evident that the close-out netting concept under French law is currently built on the concepts of termination and set-off, these elements are regulated by the rules or agreements of the market so that

31 ROUSSILLE (2001) 311.

32 See article 33 of Law No. 87-416 of 17 June 1987.

33 See Title III of Law No. 93-1444 of 31 December 1993.

34 See former article L.431-7 of the Financial Code as amended by Ordinance No. 2005-171 of 24 February 2005.

from inception close-out netting was subject to a type of 'self-regulation' by the market which was given recognition by law.

#### *8.3.2.1 Relationship with Set-off*

As noted above, the French legislator resorted to the idea of set-off to develop close-out netting but referred to the rules of the market to regulate its modality of operation. This raises the question whether any aspects of set-off, besides the economic one of achieving a single payment amount, also feature in the close-out netting concept. Both set-off and close-out netting are voluntary in nature and depend on the will of the parties to be put in operation. They serve specific, but different, purposes assigned by law. It has been seen in Chapter 5.2.1 that set-off under French law is a means of extinguishment of obligations whilst the provisions on close-out netting in articles L.211-36 *et sequentes* of the Financial Code have been placed under the heading '*Compensation et cessions de créances*' to describe the indemnification function performed by close-out netting.[35] Thus, close-out netting is a mechanism for contractual indemnification in the sense that it permits parties to establish by contract the modalities of valuation for the prejudice suffered from the early termination of the contract.[36] The respective laws have been drafted to achieve these purposes and do not appear to have generated controversial debate on the fairness or morality of the applicable provisions.

The fact that close-out netting developed under its own separate law, without being limited by set-off rules does not mean that the development of close-out netting was not influenced by the civil law system to which it belongs. Firstly, the reference to the modality of set-off in article L.211-36-1 of the Financial Code to refer to the method of achieving a net amount in itself indicates the close relationship between set-off and close-out netting in the mind of the legislator. However, it is surprising that with the resort by the market to other contractual methods of achieving a net amount, such as by novation, the legislator continues today to refer to set-off as the modality for achieving a net amount.[37] Second, civil law systems are traditionally monopolised by legislation. Party autonomy does not constitute an external source of law in a civil law system. With the emergence of new netting contracts in the financial markets, the French legislator promulgated legislation as early as 1987[38] to grant recognition to the close-out netting provisions of these contracts and thus ensure their enforceability. It is true that termination and set-off are the two main constitutive elements mentioned

35 The term '*compensation*' as used in this heading is not to be translated as set-off but as indemnification or reparation. The close-out netting provisions have been consistently placed under this heading since the enactment of article 52 of Law no. 96-597 of 2 July 1996 which was promulgated as the former article L.431-7 of the Financial Code.

36 See for instance CAILLEMER DU FERRAGE (2001) 5.

37 GAUDEMET (2010) para 468; AUCKENTHALER (2001) para 3.

38 Law no. 87-416 of 17 June 1987 on the securities lending market.

in the law and hence the reference to '*résiliation-compensation*', but from inception the legislator granted recognition to the contractual modalities of set-off provided these were in conformity with the provisions of the rules of the relevant financial market association or of the master agreements in place for that market.[39] Hence, from inception there was no direct influence of the rules of legal set-off on the development of close-out netting. This is also evidenced in the treatment of set-off and close-out netting in insolvency whereby claims arising pre-insolvency need to be connected for set-off to be allowed in terms of article L.622-7, I of the Commercial Code consistent with its function as a means of payment, whilst close-out netting enjoys an unconditional derogation from the application of insolvency law in terms of article L.211-40 of the Financial Code. It may thus be concluded that the influence on the recognition of close-out netting provisions under French law was conceptually from set-off but operationally from the market which managed to obtain statutory recognition of the termination, valuation and set-off modalities foreseen in its association rules or master agreements.

#### *8.3.2.2 Scope of Application*

It is expected that the scope of application of the close-out netting regime is affected by the specific purpose given to it by the French legislator as a contractual indemnification mechanism for the financial markets. The scope of application has been virtually changed with every amendment of the French close-out netting regime.[40] In relation to the material scope, the trend has always been to increase the scope of application to cover more markets. This was done either to cover new emerging markets or to resolve doubts whether existing markets, as in the case of the repo market, were adequately covered by the existing close-out netting regime. Notwithstanding this constant expansion, at the time of the implementation of the FCD it was considered that the material scope was still not sufficiently wide to cover the type of financial obligations falling within the material scope of the FCD and specific amendments were therefore required to remedy this limitation.

Whilst the material scope has been constantly widened, the personal scope has at times been widened and occasionally limited. In the 1987 regime, there was no particular status attached to the parties who could benefit from the close-out netting regime related to the securities lending market. In subsequent close-out netting regimes at least one of the parties had to be a designated financial institution, except for the global netting

39 See, for instance, Law No. 93-1444 of 31 December 1993 which introduces a new article 2 to the law of 28 March 1885 on the futures market providing that claims are to be set-off in accordance with the valuation modalities foreseen in the market association rules or the master agreement in place whilst termination may take place '*en plein droit*' in relation to those claims.

40 A review of the main amendments to the French close-out netting regime was made in Chapter 5.3.

regime adopted in 2001 where both parties were required to be designated entities.[41] In the 2005 amendments[42] to the former article L.431-7 of the Financial Code implementing the FCD, physical persons were excluded from the scope of the close-out netting regime, only to be reintroduced in the July 2005 amendments.[43] Even when implementing the FCD, the legislator chose a partial opt-out of the scope of application by adopting a wide material scope to cover obligations which in terms of Article 2(1)(f) of the FCD 'give a right to cash settlement and/or delivery of financial instruments' where both parties are designated persons, whilst reserving the narrower material scope relating to contracts on financial instruments listed in articles L.211-1 and L.211-36 of the Financial Code if only one of the parties is a designated person. The close-out netting regime, even after the FCD, remained separate from the financial collateral regime, the latter being regulated under article L.211-38 *et sequentes* of the Financial Code and as a result it is not necessary that a close-out netting provision forms part of a financial collateral arrangement to benefit from the regime of article L.211-36-1 of the Financial Code.

The frequent changes in particular prior to the implementation of the FCD imply that party autonomy was not considered as an external source of law and the developing markets required specific statutory recognition to ensure the enforceability of their close-out netting provisions. It appears that while the legislator was willing to increase the material scope of the law, albeit in a piecemeal manner, to allow for the recognition of close-out netting provisions in a wider range of contracts, this was not always the case in relation to the personal scope of the law. This is most evident in relation to the former article L.431-7 of the Financial Code as amended by the Law of 15 May 2001 which recognised the validity of close-out netting arrangements for financial instruments concluded by parties at least one of whom was a designated person, but only permitted global netting across different agreements if both parties were designated persons. A similar situation applies under the current law where a wider material scope is only possible if both parties are designated persons. The legislator was therefore more concerned to cover more products under the indemnification mechanism brought about by close-out netting, rather than protect the different range of parties contracting on those products.

It is not easy to explain the approach taken by the legislator. The willingness of the legislator to accommodate new markets could be considered in line with the contractual indemnification function which the close-out netting law is meant to perform, but it could equally reflect submission to the pressure of the markets to recognise more types of financial contracts and also the desire to remain competitive in this area of law which was generating legislative developments in other jurisdictions. In other words,

41 The restriction of the benefit of global netting to professional parties was made on the basis of an extensive debate in Parliament as has been referred to in Chapter 5.4.2.

42 Ordinance No. 2005-171 of 24 February 2005.

43 Law No. 2005-842 of 26 July 2005.

the influence of the *lex mercatoria* may have had a role to play in shaping the type of recognition granted to close-out netting under French law. In relation to the personal scope the legislator had probably more leeway to decide whether to take a more pro-debtor or pro-creditor approach once the close-out netting provisions of the financial market itself were already covered by the law. The widening and narrowing of personal scope arguably indicate the hesitation of the legislator to take a more pro-creditor approach and this is reflected in the implementation of the FCD which, as has already been stated, applies a narrower material scope if one of the parties is not a designated person. On the other hand, this approach does not help explain or justify why the law recognises even agreements concluded with physical persons given that this is excluded by the FCD and extends the purpose of the close-out netting regime beyond its original scope of indemnification for the financial markets. The extension of the close-out netting regime to physical persons is also arguably evidence that considerations of systemic risk were not taken into account when drafting these laws.

### *8.3.2.3 Recognition 'In Accordance With Its Terms'*

Since the first close-out netting law of 1978[44] dealing with the securities lending market, the law, although amended on numerous occasions, continued to follow approximately the same style and sequence of provisions. Prior to the implementation of the FCD, former close-out netting laws provided that in respect of designated parties and designated financial contracts, the law will give effect to the contractual modalities of termination and set-off if these modalities conform to the rules of the relevant market association or of the master agreement in place nationally or internationally for that market.[45] Each law, including the current law, ends with the rule that third parties may not oppose the enforceability of such agreements by way of civil execution action and that insolvency law shall not affect their enforceability. Initially these laws focused on the modalities of termination and set-off, but valuation was soon added as another modality,[46] though it was understood *ab initio* that valuation according to the market association agreements and master agreements was already included in the set-off modality.[47]

44 Former article 33 of Law no. 87-416 of 17 June 1987.

45 One temporary exception applied in the case of repos where under article 12V of the law of 31 December 1993 the approval of the Governor of the *Banque de France* was required prior to enforcing close-out netting provisions of repo agreements. This exception could be explained by the loan-like features of repos which necessitated additional control on their enforcement. In any case, this control was deleted by the Law no. 96-597 of 2 July 1996.

46 The first mention of all three constitutive steps of close-out netting occurred in article 52 of Law no. 96-597 of 2 July 1996.

47 See, for instance, the new article 2 added by Law no. 93-1444 of 31 December 1993 to the Law of 28 March 1885 which provides that: '*Les dettes et les créances afferents aux marchés mentionnés à l'article 1er […] sont compensables selon des modalités d'évaluation prévues par lesdits règlements ou ladite convention cadre*.'

Although the scope of application of the French close-out netting regime was widened in 2005 to implement the provisions of the FCD and the reliance on the rules or master agreements of the market associations to give recognition to close-out netting agreements was deleted,[48] the legislator did not change the style of drafting of the provisions. As a consequence, since the French legislator continued to adapt existing legislation rather than create an *ad hoc* law when implementing the FCD, the principle that close-out netting provisions are enforceable in accordance with their terms does not appear *verbatim* in the French close-out netting law. Instead, the French legislator relied on the already available provisions providing for the enforceability of close-out netting provisions. This has been achieved in three ways. First, article L.211-36-1, I of the Financial Code permits the termination and set-off of eligible financial obligations in terms of one or more agreements or master agreements entered into between the parties. Second, paragraph II of the same article grants protection to the contractual modalities of termination, valuation and set-off against third party action under a civil execution procedure or a right of opposition. Third, article L.211-40 of the Financial Code provides, *inter alia,* that the provisions of insolvency law contained in Book VI of the Commercial Code should not hinder the applicability of the provisions mentioned above.

It may seem *prima facie* that these protections are tantamount to providing for the enforcement of a close-out netting provision in accordance with its terms. Whilst for the most part they are, it has already been seen in Chapter 5.3 that the absence of a general rule stating that a close-out netting provision will be enforced in accordance with its terms means that any restriction which cannot be classified as either third party action within the meaning of article L.211-36-1, II of the Financial Code or which does not fall under the derogations of article L.211-40 of the Financial Code may hinder the full recognition of close-out netting provisions.[49] Three such instances have been identified in Chapter 5.3, among them the conservatory acts that may be exercised by the ACPR under article L.612-33 of the Financial Code. It is arguable that the French legislator was convinced that party autonomy was adequately protected under the existing provisions of

48 These two aspects, namely the material scope and the reliance on market association rules or standard agreements are the two main issues requiring changes to the French close-out netting regime in order to implement the FCD. See *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. The widened scope of application following the implementation of the FCD may have altered, at least functionally, the purpose of the close-out netting law as an indemnification mechanism.

49 Former versions of the French close-out netting regime may be considered more adequate in fulfilling the standard that a close-out netting provision is enforceable in accordance with its terms. Thus, the close-out netting regime promulgated by Law No. 93-1444 of 31 December 1993 provided that: '*Les dispositions du présent article sont applicables nonobstant toute disposition législative contraire*', implying that no law could supersede the exercise of party autonomy as foreseen by the same close-out netting regime.

article L.211-36-1 of the Financial Code which has withstood the test of time, but it could be that new laws, not foreseen at the time when this article was drafted, could have an effect on the extent of recognition given to close-out netting provisions as provided by the FCD.[50] This is different from the situation where the legislator, as in the case of resolution regimes, expressly creates an exception or an alteration to the party autonomy principle of the close-out netting regime but is a case where unknowingly and on account of the nature of certain powers given under a separate law, these may supersede the provisions on close-out netting and thus restrict the extent of recognition granted. Thus, the fact that the French legislator may have opted to implement the FCD by relying on the previous recognition already granted to close-out netting arrangements and simply widened the scope of application may not have been sufficient to incorporate the party autonomy standard sought to be achieved by the FCD. This also brings out the difference in interpretation between a civil and common law jurisdiction. Whilst under English law the specific derogations from designated provisions of insolvency law was not interpreted to imply that other provisions of insolvency law continue to apply, under French law the general derogations from insolvency law and third party civil action have, to the contrary, been interpreted to imply that the application of other provisions of the law is not excluded.

#### *8.3.2.4 Congruence with State Insolvency Goals*

The lack of conditionality attached to both the recognition of close-out netting provisions and to the derogations from other laws is particularly noticeable. The FCD itself obliges Member States in Article 8(2) to ensure that in relation to financial obligations arising on the day but after the moment of opening of insolvency proceedings, the solvent party must prove that it was not aware nor could have been aware of the commencement of such proceedings. This obligation is not implemented in the close-out netting regime of article L.211-36-1 of the Financial Code. The French regime does not even set a time restriction when obligations subject to close-out netting should have been entered into to be considered enforceable so that both pre-and post-insolvency claims seem to be equally eligible.[51]

50 Although article L.211-40 of the Financial Code was slightly modified by Law no. 2019-287 of 20 April 2019 to exclude the application of article 1343-2 of the Civil Code on the compounding of interest, as noted in Chapter 5.1.

51 It may be recalled that in Chapter 5.4.1 it was noted that until the Act of 26 July 2005 only pre-insolvency creditors were subject to the constraints of insolvency proceedings whilst post-insolvency creditors were free to continue trading and enforce their security as this was considered necessary for the continuance of the business. This implies that the *pari passu* principle was at the time only applied to pre-insolvency creditors and may help explain the legal context in which the close-out netting regime applied.

Similarly, the derogation from the provisions of insolvency law in terms of article L.211-40 of the Financial Code is not subject to any restrictions such as relating to suspect periods or fraudulent transfers. Typical of a civil law jurisdiction, the law is what the legislator states it is and it does not seem that issues of morality or controversial debates on the effect of close-out netting on the *pari passu* principle under French law have arisen. However, the privileges granted in relation to close-out netting rights necessitate some balancing of interests and it cannot be the case that the law can permit the enforcement of close-out netting provisions for instance under fraudulent circumstances. In these situations, it will be up to the courts to give an equitable interpretation to the enforcement of close-out netting contracts on the basis of general principles of law to fill the gap left by the legislator.

This seemingly unconditional exercise of close-out netting rights without the imposition of restrictions evidently goes against the business rescue culture sought to be instilled by French insolvency law. It has been suggested in Chapter 5.4.2 that the direction taken by the French legislator in close-out netting may have been influenced by the public policy of the Government that the French economy should remain competitive within the global market. This trend is visible throughout the various amendments of the close-out netting regime which relied heavily on market rules and agreements for the recognition granted to party autonomy. In addition, it appears that the main point of discussion focussed on the personal scope of application and to what extent it should include persons outside of the financial markets. This may be an indication that although the French legislator was influenced by the public policy of the French government of the time to remain competitive in the market by providing more protection to close-out netting agreements entered into by the financial market, it is arguably an indication that the legislator still wanted to retain some restrictions in relation to the type of parties benefitting from such protection possibly in order to keep to the original purpose of the close-out netting of an indemnification mechanism for the financial markets. This trend, as will be seen in more detail later in this chapter, has been maintained in the partial opt-out exercised by the French legislator when implementing the personal scope of the FCD.

### 8.3.3 US Law

Under US law the recognition of close-out netting provisions was borne out of the notion of the safe harbours of the Bankruptcy Code. Prior to the enactment of section 560 of the Bankruptcy Code, the safe harbours protected only the close-out aspect of financial transactions, allowing parties to designated contracts to terminate open market positions upon the insolvency of one of the parties. With the enactment of section 560 in 1990 the Bankruptcy Code recognised in addition the offset and netting of termination values in relation to swap agreements. This historical development of close-out netting under US law may have influenced the perspective taken in US doctrine that close-out and netting are two separate contractual rights.[52] Indeed, contrary to the French legislator who at the outset combined two existing concepts, namely termination and set-off, to create a new concept, *i.e.* close-out netting, the US legislator set out to protect designated contractual rights from the application of insolvency law, which included the separate rights of close-out and netting. Two remarks may be made on the historical evolution of close-out netting. First, since the original safe harbours granted protection only to the close-out of financial transactions,[53] it can be argued that the solvent creditor had to resort to ordinary set-off rights, where applicable, to reduce its exposure to a net amount. Second, it may be noted that the protection of the contractual rights of offset and netting when combined with a close-out of the designated agreement was introduced in 1990 *via* section 560 of the Bankruptcy Code in relation to swap agreements at a time when the derivatives industry led by ISDA was lobbying worldwide for the introduction of close-out netting legislation. Further reflections on both issues are made below.

#### *8.3.3.1 Relationship with Set-off*

It has been stated in Chapter 6.2.2 that ordinary set-off did not influence the development of close-out netting under US law given that the latter developed under the different notion of the safe harbours. The beginnings of set-off under both English and US laws were similar, in that both began as pleading tools to avoid multiplicity of actions and later were considered as a substantive concept and a form of security, based on equity considerations. However, whilst under English law insolvency set-off developed into a mandatory concept which operated with flexibility and was initially resorted to for the protection of close-out netting provisions, under US law set-off is of a voluntary nature and operates rather inflexibly upon insolvency where court intervention is often required for its enforceability. Arguably, US ordinary set-off law was not considered a suitable model to resort to for the protection of close-out netting provisions and hence did not influence its development.

However, what is rather unexplainable is the sudden severance of the link with ordinary set-off when creating the safe harbour protection of the contractual rights of offset and netting. Thus, to contrast with the French position, the reference to set-off in article L.211-36-1 of the French Financial Code as one of the constitutive elements of close-out netting is the same reference to contractual set-off regulated by the provisions of the Civil Code but adapted in order to provide enhanced protection to party autonomy in the recognition of close-out netting provisions. US law, on the

52 See, for instance, BLISS & KAUFMAN (2006) 58. The consideration of close-out and netting as two separate rights, and not as constituting a single concept, was discussed in Chapter 6.2.

53 11 U.S.C. §§ 555, 556, 559.

other hand, has created a different concept of offset in section 560 of the Bankruptcy Code which achieves the same result as ordinary set-off, *i.e.* a single payment amount, but has developed it on the basis of the separate notion of the safe harbours. This separation between ordinary set-off and close-out netting under the Bankruptcy Code indicates that the US legislator was not influenced by the legal doctrine and the pro-debtor influence that could have been exerted by ordinary set-off law.

It is more difficult to ascertain whether the same severance from ordinary set-off also applies to the term 'netted' used in section 403(1) of FDICIA since the terminology of this provision is similar to that used in modern close-out netting legislation such as the EU's FCD. This issue is unclear because the reference to offset is missing from this provision and this could be interpreted to mean that any setting off of obligations to achieve a net amount taking place under section 403(1) could be referring to ordinary set-off rather than to offset as understood under the safe harbours. However, the preferred view taken by this research is that with the adoption of the safe harbours and the immediate severance this brought from the influence of ordinary set-off, it seems hardly likely that with the introduction of FDICIA, which is arguably meant to modernise the close-out netting regime, the legislator would decide to turn back the clock and re-introduce the requirements of ordinary set-off.

Not only did the US legislator sever links with ordinary set-off when creating the safe harbours so that the same philosophy of ordinary set-off is not meant to apply to close-out netting, but it is also not clear what statutory purpose has been given to close-out netting. Since resort cannot be had to ordinary set-off to get an indication of this purpose, reference will be made to the positioning of close-out netting under US law. A consideration of the placements of the provisions of the two close-out netting regimes does not provide a consistent picture of the purpose sought to be achieved by close-out netting. The safe harbours of the Bankruptcy Code are placed under Subchapter III of Chapter 5 dealing with 'The Estate' of the insolvent debtor. This does not reveal the specific purpose of close-out netting but has probably been placed there by the legislator since the safe harbours are actually providing protection to designated contractual rights from the provisions of the Bankruptcy Code. The close-out netting provisions of FDICIA are placed under Subchapter 1 dealing with 'Bilateral and Clearing Organization Netting' in Chapter 45 on 'Payment System Risk Reduction' of Title 12 of the US Code on Banks and Banking. The placing of the bilateral close-out netting regime applying generally to the financial market in a chapter on payment systems also does not help to provide a clear indication of the specific purpose assigned by the legislator to bilateral netting. Possibly, the placement of the bilateral close-out netting regime under a chapter on payment system risk reduction may imply that the bilateral close-out netting regime in the mind of the legislator serves a risk mitigation purpose which is a rather generic purpose (*i.e.* not a functional purpose) and only helps to an extent to understand the direction or influence which the purpose may exert on the US legislator when granting recognition to close-out netting provisions.

### *8.3.3.2 Scope of Application*

The personal and material scope of application of the two close-out netting regimes may shed more light on the purpose given to these regimes under US law and the influences which guided the legislator in the recognition of close-out netting. It has been seen in Chapter 6.2 that the close-out netting regime of section 560 of the Bankruptcy Code applies to swap agreements which are widely defined to include a vast range of derivative arrangements, and any transaction which is similar to these arrangements and any collateral and other credit enhancements.[54] It also applies to any swap participant or financial participant. Swap participant includes any entity which has an outstanding swap agreement with the debtor at any time before the filing of the bankruptcy petition[55] and a financial participant has to fulfil a number of threshold requirements as seen in Chapter 6.3 which indicate that it is a major market player.[56]

Two remarks may be made about the scope of application of section 560. First, consistent with the previous safe harbours but rather different from the close-out netting regimes of England and France which protect close-out netting provisions in financial arrangements related to designated financial instruments, the protection is granted to close-out netting rights derived from a particular agreement. The impression is given that the US legislator wanted to protect a particular market, namely the derivatives market, even perhaps to the detriment of leaving out segments of the financial market which cannot fall within this definition such as the repo market. It may also be noted that the list of agreements that constitute a swap agreement and the wording used to expand the meaning to equivalent agreements is reminiscent of the wording used in the successive ISDA Model Netting Laws to define a qualified financial contract.[57] These two elements, *i.e.* the focus on the derivatives market and the manner of defining swap agreements, is arguably an indication of the influence of ISDA on the enactment of section 560.

Second, the personal scope may include either a party to the swap agreement, which could be any entity, or a financial participant which has to fulfil certain threshold criteria. Since any party to a swap agreement may qualify for protection, it appears superfluous to refer also to a party fulfilling threshold criteria. Perhaps one can here detect a conflict between the influence of the ISDA Model Law which also offers protection to any

54 11 U.S.C. § 101(53B).
55 11 U.S.C. § 101(53C).
56 11 U.S.C. § 101(22A).
57 See ISDA 2018 Model Netting Act, Part 1 ('Definitions'). Previous versions contained similar wording.

party to a qualified financial contract and the risk mitigation role performed by close-out netting under US law which influenced the purported restriction to major market dealers.

Section 403 of FDICIA is an attempt to bridge the gap where the Bankruptcy Code safe harbours do not adequately protect close-out netting provisions in relation to certain financial contracts. It attempts to do so in two ways. First, section 403 does not impose any restriction on the type of netting contract that is covered by this provision[58] so that the material scope is open. This is rather unusual and cannot be clearly attributed to either the influence of the drafting of the safe harbours or of the rules or standard agreements of market associations. It may also be incidental to the fact that the definition of 'netting contract' in section 402(14) of FDICIA covers also rules and agreements of payment systems and clearing organisations so that the legislator considered it practical not to limit the material scope of the definition in order to cover a wide range of netting contracts and thus cater for the wider scope of FDICIA.

Second, FDICIA limits the type of financial institutions that may be parties to a netting contract. A financial institution is defined as 'a broker or dealer, a depository institution, a futures commission merchant, or any other institution as determined by the Board of Governors of the Federal Reserve System.'[59] It may be noted that the list of financial institutions mentioned in this definition is an unmistakable reference to the types of parties covered by the safe harbours preceding the enactment of section 560 of the Bankruptcy Code which did not receive adequate protection of their close-out netting provisions. It is also to be noted that the Federal Reserve Board determined through the issue of Regulation EE[60] that a financial institution qualifies for protection of their netting contracts if it meets the same business thresholds set for the qualification of 'financial participant' referred to in section 560 of the Bankruptcy Code. The end result is therefore that on account of the high thresholds which a party must fulfil in order to qualify as a financial participant, an element of systemic risk may have been instilled by FDICIA since arguably only major market dealers qualify under this regime, whatever the type of netting agreement, and provided both parties are considered financial institutions, whilst the section 560 regime of the Bankruptcy Code is open to any party (being any entity) to a swap agreement.

The various influences which have shaped the US close-out netting regime have resulted in different levels of protection given to close-out netting provisions depending on the scope of application of the particular

58 In this respect, see the definition of 'netting contract' in section 403(14)(A) of FDICIA which refers, *inter alia*, to 'a contract or agreement between 2 or more financial institutions, clearing organizations, or members that provides for netting present or future payment obligations or payment entitlements […] among the parties to the agreement […].'

59 12 U.S.C. § 4402(9).

60 Regulation EE, 12 C.F.R. § 231.

regime. In terms of scope of application, those most widely protected are parties to swap agreements since any entity to a derivatives arrangement may benefit, while parties to other netting contracts are required to fulfil the thresholds established for a financial institution to get protection under FDICIA. Other than general statements made by Congress that safe harbours are required to instil public confidence in the respective markets and to protect against systemic risk,[61] there does not appear to be a particular justification why swap agreements, which have been widely defined to cover the derivatives market, should be given preferred treatment over other markets such as the repo market. One plausible explanation given above is the influence and pressure exerted by derivative market associations such as ISDA on the US legislator at the time of the enactment of section 560 of the Bankruptcy Code. Another could be the global expansion of close-out netting legislation at the time of the adoption of the FCD which could have led to the expansions of all the safe harbours in 2005 through the widening of definitions in BAPCPA. It will be seen below whether these same influences have also resulted in different levels of recognition granted under the different close-out netting regimes.

#### *8.3.3.3 Recognition 'In Accordance With Its Terms'*

It has been noted that when enacted in 1990 section 560 of the Bankruptcy Code followed the style of drafting of the existing safe harbours. A number of consequences follow from this situation. In some respects, the recognition given to close-out netting provisions seems quite wide. Thus, the protection is of a contractual right of a swap participant or financial participant. *Prima facie* there does not seem to be the imposition of any mutuality requirement, though it was argued in Chapter 6.2.2 that this is most probably due to the linguistic construction of the provision which protects contractual rights rather than netting contracts and should not be read to imply that mutuality is not required. Following the style of the preceding safe harbours, the source of a contractual right is widely defined to include not only rules and contracts of market associations, but also any right 'whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.' There is no link or reference in section 560 itself to the taking of resolution measures under other laws which could affect the operation of a close-out netting provision, although it should be recalled that bankruptcy proceedings of banks are regulated by FDIA and not the Bankruptcy Code. In other respects, however, the influence of the existing safe harbours has restricted the party autonomy role.

61 See KRIMMINGER (2006).

Thus, because it is influenced in its drafting by the preceding safe harbours the protection given to close-out netting is only from the application of the stay, avoidance and other titles or procedures under the Bankruptcy Code.[62] This protection does not seem to extend, for instance, to the actions that may be instituted by third party creditors outside of bankruptcy proceedings, as is the case under article L.211-36-1, II of the French Code. By international standards this protection may be considered rather limited, in particular taking into account that section 560 of the Bankruptcy Code does not contain the standard that close-out netting provisions are to be effective in accordance with their terms. These *lacunae* were taken up by the US legislator when drafting section 403 of FDICIA.

It will be recalled that the provisions of section 403 of FDICIA apply to any netting contract entered into between any two financial institutions that meet the business thresholds set by Regulation EE which would qualify them as systemically important entities. This provision seems to cater for all the restrictions and empowerment contained in a modern close-out netting regime based on international and market principles. It applies solely to mutual netting contracts ('between any 2 financial institutions') which 'shall be terminated, liquidated, accelerated, and netted in accordance with, and subject to the conditions of, the terms of the applicable netting contract.'[63] The notion of offset, referred to, and probably also created, by section 560 of the Bankruptcy Code, does not feature in section 403 of FDICIA and it is not clear if it continues to apply through a wide interpretation of the modality of netting. This may be contrasted with other laws, such as French law, which continues to refer to set-off as a generic modality for achieving a close-out amount. The party autonomy enjoyed by financial institutions is made to apply '[n]otwithstanding any other provision of State or Federal law' subject only to the supremacy of resolution and other conservatory measures and orders which may be taken under designated provisions. This ensures that, save in the exceptions mentioned by section 403(a) of FDICIA, the effectiveness of a close-out netting provision is ensured *erga omnes* since the derogation applies not only from bankruptcy law but any other law including those that may give third party creditors the right to impugn a close-out netting provision.

Further repercussions on the recognition granted to close-out netting provisions arise from the style of drafting of the netting regimes. Thus, reference is still made today in section 560 and the other safe harbours of the Bankruptcy Code under the meaning of 'contractual right' to the rules and bylaws of market associations or the terms of their market agreements, including rights 'whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice.' Although this wording is reminiscent of the type of wording

62 The derogation does not apply to fraudulent transfers with actual intent to hinder, delay or defraud creditors as foreseen in Chapter 6.2.2.

63 12 U.S.C. § 4403(a).

used under the former article L.431-7 of the French Financial Code referring to the terms set by the rules of market associations (which has now been removed), section 560 of the US Bankruptcy Code goes much further and grants important derogations from the insolvency law even to rights derived from unwritten agreements and customary law. It is difficult to understand why this wide scope of contractual rights has remained constantly applicable throughout the expansion of the safe harbours and today applies to the protection of close-out netting under section 560 of the Bankruptcy Code. Although US law, being partly based on the common law system, may recognise customary law as a source of law, it is difficult to explain the reason for the continued recognition of contractual rights arising from this source and from unwritten agreements, given the significant effect of the derogations from insolvency law. The continued retention of this reference cannot nowadays be the result of the pressure exerted by market associations since the type of complex agreements covered by section 560 of the Bankruptcy Code are covered either by master agreements or, at most, by written rules or bylaws of financial market associations but not by unwritten agreements. It would thus seem that the legislator has retained in place a wide definition of the source of contractual rights which was contained in the previous safe harbours without reassessing whether this continues to be justified or necessary.

Section 403 of FDICIA, on the other hand, portrays a completely different style from section 560 of the Bankruptcy Code. The subject matter, and therefore the focus, of section 403 is the protection of a netting contract, as opposed to section 560 where the protection centres on contractual rights, not necessarily forming part of a netting contract. Although varying in material and personal scope, the drafting of section 403 is reminiscent of the drafting of Regulation 7 of the FCD, including the standard that a close-out netting provision is to be enforceable in accordance with its terms.

To an outsider, there is little logic why the US legislator enacted two separate, but overlapping, netting regimes in a short span of time except to assume that the legislator was under pressure to enact close-out netting legislation in this piecemeal fashion. In 1990, when the derivatives industry was proliferating, the US legislator enacted section 560 to protect close-out netting provisions in swap agreements which was amended in 2005 by BAPCPA to, *inter alia*, increase the type of agreements that could be protected. In 1991, the US legislator enacted section 403 of FDICIA which, albeit restricted to major market players only, is meant to apply to all financial contracts concluded by the designated financial institutions. It has been discussed in Chapter 6.3 that FDICIA was meant to cover those transactions which did not fall within the definition of swap agreement, in particular those transactions covered by the safe harbours preceding the enactment of section 560 of the Bankruptcy Code. It is not clear which is the *lex specialis* between the two netting laws for the parts where they overlap since the section 560 regime is more specific on the type of agreements covered by the safe harbour whilst FDICIA is more specific on the designated parties.

It would seem that the opportunity was lost for the US legislator when enacting FDICIA to unify all the existing safe harbours into one regime and thus resolve the current overlap between the existing regimes.

### *8.3.3.4 Congruence with State Insolvency Goals*

It has been seen in Chapter 6.4 that the US legislator adopts a particularly conservative and pro-debtor approach to protect the value of the estate. As a general rule the commencement of bankruptcy proceedings acts as an automatic stay against the enforcement of any lien against, or the offset of any debts owed to, the debtor.[64] Therefore, all creditors are prohibited from removing or using any part of the debtor's estate to satisfy their claims. Each creditor must file a claim and then wait for the bankruptcy trustee to distribute the debtor's estate to satisfy each claim.[65] In addition, an executory contract of the debtor may not be terminated based on the financial condition of the debtor or the commencement of a bankruptcy case.[66]

In the light of these and other pro-debtor insolvency rules considered in Chapter 6.4, and given the different approaches of the two close-out netting regimes, it may be difficult to establish a single purpose or state insolvency goal which explains the type of recognition given to close-out netting provisions under these two regimes. The broad scope of application and the wide derogations applicable under both the section 560 Bankruptcy Code regime and the FDICIA regime are hard to compare with, for instance, the inflexible rules of ordinary set-off and the extent of court intervention required to both terminate executory contracts as well as to set off mutual claims upon bankruptcy. The focus of the section 560 regime is on the protection of close-out netting provisions in swap agreements from the provisions of the Bankruptcy Code, whilst that of FDICIA is the protection of close-out netting provisions in any type of financial contract concluded by systemically-important financial institutions from the provision of any law with the exception of specified resolution and conservatory measures. Apart from the type of derogations being granted which has already been discussed above, the fact that the legislator has switched from protecting the type of market, albeit widely defined to include most of the derivatives market, to protecting systemically important financial market players in a span of one year gives an indication that the US legislator was not focused on a particular insolvency goal or public policy, but was rather influenced by the expansion of the derivatives market by first offering protection to the derivatives industry in section 560 and then to its major members in the FDICIA regime, but taking into account the supremacy of resolution and conservatory measures. This influence is made more evident by the fact that the legislator did not consider the necessity of amalgamating the

64 11 U.S.C. § 362(a).
65 11 U.S.C. § 704.
66 11 U.S.C. § 354(e)(1)(A).

two regimes to establish a single focus of the close-out netting regime but, as with the preceding safe harbours, continued enacting law to meet the developments and give in to the pressure of the market.

## 8.4 Recognition by EU Law of Close-out Netting Provisions

A major influence on the close-out netting regimes of England and France is undoubtedly the adoption of the EU's Financial Collateral Directive. Both jurisdictions, as did the other EU Member States, transposed the provisions of the FCD into domestic law, including its Article 7 on the recognition of close-out netting provisions. The interpretation of the close-out netting provisions under both the FCD and the BRRD has been examined in Chapter 3. This part will analyse how the minimum level of recognition of close-out netting provisions required to be implemented by the FCD has influenced the development of the close-out netting regimes of England and France.

The FCD was adopted in June 2002 and was primarily intended to introduce an EU framework for financial collateral to harmonise the significant discrepancies in the laws of the EU Member States insofar as regards the formalities required to enforce a title transfer and a security-type of collateral arrangements. The FCD therefore is limited in scope to financial collateral arrangements entered into between designated entities. No business or size thresholds have been set by the FCD for the eligibility of the entities that may benefit from the Directive since, given the primary purpose of harmonising the EU framework for financial collateral, none were required. As a secondary issue, the FCD also seeks to harmonise the recognition of close-out netting provisions typically contained in the financial collateral arrangements falling within the scope of the FCD.[67] As a consequence, the scope of application of Article 7 of the FCD is the same as that intended for the harmonisation of the formalities of financial collateral arrangements.

It is worth noting that Recital (14) which provides a justification for Article 7 refers to the need to maintain '[s]ound risk management practices' and to enable counterparties 'to manage and reduce their credit exposures', but does not appear to contemplate the protection against systemic risk which is more typically associated with the size, volume of business and interconnectedness of a counterparty. Whilst it will be discussed below how this has influenced the English and French regimes, it would seem that should a Member State introduce a type of size threshold or interconnectedness or other similar consideration for the recognition of close-out netting

67 In terms of the European Commission's *Working Document on Collateral from the Commission to relevant bodies for consultation*, 'The form of netting which is particularly linked to collateral arrangements is "close-out" netting, which forms a key part of the enforcement mechanism for repo and other title transfer collateral arrangements.' EUROPEAN COMMISSION 2000 Working Document, 13.

provisions in accordance with their terms, it is questionable whether this would meet the minimum harmonisation standards set by the FCD and as such not be considered as fully implementing this Directive.

On the other hand, as a type of minimum harmonisation instrument, Member States may go beyond the requirements of the FCD. The standard set by Article 7(1) of the FCD is to grant recognition to a close-out netting provision in accordance with its terms notwithstanding the existence of winding-up or reorganisation proceedings of the counterparty and notwithstanding any purported assignment or attachment in relation thereto. Thus, as a minimum Member States should provide derogations to protect close-out netting provisions from their insolvency laws and from third party (civil) action. It appears that protection to a close-out netting provision should be acceptable up to the day of, and even after the moment of commencement of, insolvency proceedings. This may be implied from a reading of Article 8(2) of the FCD which provides that in such cases the solvent party is required to prove that it was not aware, nor could have been aware, of the commencement of such proceedings. The presumption is that after the day of the commencement of insolvency proceedings, any financial transaction entered into is deemed to be done in bad faith.

The standard set by the FCD for the recognition of close-out netting provisions is subjected to two exceptions. Article 4(6) of the FCD recognises and gives pre-emption to 'any requirements under national law to the effect that the realisation or valuation of financial collateral and the calculation of the relevant financial obligations must be conducted in a commercially reasonable manner.' In the same vein, Recital (15) provides that the FCD is to apply without prejudice to 'any restrictions or requirements under national law on bringing into account claims, on obligations of set-off, or on netting', citing as examples of these restrictions the requirement of reciprocity and the lack of knowledge or constructive knowledge of the imminent or pending insolvency. It is understood that at the time of its introduction, the FCD was going to bring about significant changes in the laws of the Member States, in particular those which still relied on the pledge regime for collateralising their financial transactions or had to rely on foreign governing laws to conclude repo agreements. These exceptions gave the opportunity to national legislators to introduce national restrictions which could affect the standard for party autonomy set by Article 7(1) of the FCD without violating mandatory or public policy national laws.

Clearly, the FCD establishes a broad framework for the recognition of close-out netting provisions which permits variation in its implementation and retention of certain national restrictions. This is to be contrasted with the scope of application of the same regime which, even though wide, Member States are expected to implement as a minimum. It is thus to be expected that whilst the manner in which the Member States have implemented the standard for the recognition of close-out netting provisions could vary significantly, the scope of application should be implemented at least as stipulated in the FCD. Whilst general remarks have already been made in part 8.3 of this chapter on the way in which the FCD has influenced the development of close-out netting in England and France, this part will compare these influences in terms of scope of application, type of derogations granted to protect party autonomy and the retention or introduction of national law restrictions. A few observations of how the FCD may have also influenced the development of the safe harbours in the US will be made at the end.

### 8.4.1 Scope of Application

By far the greatest influence of the FCD on English law is that it instigated the English legislator to enact close-out netting legislation in terms of the FCAR. Although the general conviction of the legislator was that close-out netting was already effective under common law, the transposition of the FCD was taken as an opportunity to address any uncertainties arising under equity or common law. Because a close-out netting statute did not exist prior to the transposition of the FCD, the scope of application of the FCD has had a profound influence on the development of English close-out netting law. The English legislator adopted faithfully the material scope of the Directive, as already explained in part 8.2 of this chapter, possibly acting under the conviction that a wider scope for the effectiveness of close-out netting was already operative under common law. As a result, the close-out netting regime is restricted to financial collateral arrangements as defined by the FCD and hence the certainty achieved by the statutory recognition of close-out netting under English law is also limited in this way. On the other hand, the English legislator chose not to be confined by the minimum requirements of the FCD in relation to the personal scope of application which was extended to include financial collateral arrangements entered into not only with designated entities, but also between any two corporate entities. This approach was based on the understanding that since no formalities applied under common law in relation to financial collateral arrangements concluded between any two persons, it was only logical to extend the personal scope beyond the confines of the FCD. In this way, the personal scope of close-out netting arrangements was automatically and similarly extended.

In France the transposition of the FCD resulted in the widening of the scope of application of the existing French close-out netting regime. Two important aspects had influenced the scope of application of the French close-out netting regime prior to the implementation of the FCD. It will be recalled that the French regime was based on the recognition of close-out netting provisions in designated markets when these provisions adhered to the rules of relative financial market associations or the terms of national or international master agreements in place for those markets. Another issue was the debate on the extent of the personal scope of the close-out netting regime to non-professional entities. For instance, it has been seen that although it was the general rule that the close-out netting regime would cover an entity dealing with any eligible person, the global netting regime was initially restricted to two professional entities contracting with each other. It is with these specific issues in mind that the French legislator implemented the FCD. The French legislator transposed the close-out netting provisions of the FCD separately from those on financial collateral arrangements and continued to amend the existing close-out netting regime of former article L.431-7 of the Financial Code[68] so that under French law the recognition of close-out netting is not restricted to financial collateral arrangements.

The obligation to transpose the FCD implied that the French legislator had to widen the material scope of the close-out netting regime. This meant that both the type of financial instruments covered by the regime had to be widened whilst the limitation relating to the adherence to the terms of the master agreements in place for the particular market had to be removed. The debate on the personal scope of the regime continued for the French legislator when implementing the partial opt-out permissible under Article 1(3) of the FCD. This is not a straightforward opt-out in the sense that legal entities have been excluded from the personal scope. Indeed, the concern of the French legislator with the personal scope is evident from the fact that a partial opt-out was adopted whereby the wider material scope of the FCD involving any contract regarding financial obligations for payment or delivery of financial instruments applies if both parties are eligible persons whilst the narrower material scope limited to contracts on specified financial instruments applies if only one party is eligible. In addition, when implementing the FCD, former Article L.431-7 of the Financial Code expressly excluded physical persons from this regime in line with Article 1(2)(e) of the FCD. However, this exclusion was later omitted so that until today both physical and legal persons may benefit from the close-out netting regime if contracting with an eligible person. Two possible explanations may be given for this development. The first is that prior to the implementation of the FCD physical persons contracting with an eligible person were not excluded and the second might be a competitive one which ensures that the French regime can reach a wider range of participants. Thus, other influences, besides that of the FCD, have shaped the scope of application of French close-out netting legislation.

### 8.4.2 Type of Derogations

The two types of derogations foreseen by Article 7(1) of the FCD required to protect the enforceability of close-out netting provisions are from the application of insolvency laws and from third party action, these being recognised as possibly the two most problematic areas of law for such enforceability. Thus, ignoring for the moment the possibility given to

68 Amended by Ordinance No. 2005-171 of 24 February 2005.

Member States to introduce or retain certain national law restrictions, this is the type of protection to close-out netting which is required to be harmonised in the EU for the recognition of close-out netting provisions.

The English legislator transposed almost *verbatim* the rule in Article 7(1)(a) of the FCD that a close-out netting provision shall take effect in accordance with its terms notwithstanding the commencement or existence of insolvency proceedings in regulation 12(1) of the FCAR but omits to mention anything about protection against third party action as provided in Article 7(1)(b) of the FCD. This is one of the instances where the English legislator did not implement a provision of the FCD because there was no need to. Yeowart *et al.* explain that there is presumably no need to implement this part of Article 7(1) since 'this would be the case in any event as a matter of English law', although they also admit that probably there was also no need to implement the first part of Article 7(1) since the general understanding under English common law is that close-out netting already worked.[69] It has been stated, however, that the fact that English law implements the first part of Article 7(1) has resolved a number of uncertainties. If at the time of implementation of the FCD there were no risks that third party action could hinder the enforceability of close-out netting provisions, it is arguably the case that the English legislator was free to decide not to implement that provision because there was no need to. However, it would be good policy to have inserted a general provision to protect close-out netting provisions from third party action since this is also a safeguard against future legislative developments which could not be foreseen at the time of adoption of the FCAR.

In relation to the protection from the application of insolvency law, the English legislator (unlike the French legislator) was not content to formulate the general rule that close-out netting provisions apply notwithstanding the commencement or existence of insolvency proceedings, but opted to disapply or modify the application of certain provisions of insolvency law, in particular as regards the provisions on insolvency set-off.[70] Without re-entering into the interpretation problems caused by this exclusion or modification of certain insolvency law provisions as this has been sufficiently dealt with in Chapter 4, this indicates that notwithstanding the assumptions made by the English legislator in the FCAR Consultation Document on the recognition of close-out netting under English common law, the English legislator still felt the need to resort to these exclusions or modifications to bring legal certainty on the recognition of close-out netting provisions. This detailed type of regulation arguably reflects the common law style of drafting where the legislator does not rely on the interpretation of general principles of law but regulates all the details deemed necessary to implement those general principles. The drafting also reflects the conviction

69 YEOWART *et al.* (2016) 222.

70 See regulations 10(1)(b), 12(4) & 14 of the FCAR.

of the legislator that close-out netting is generally protected from insolvency law but, for certainty's sake, certain insolvency law provisions have been excluded or modified to avert any doubts as to their applicability.

The situation under French law appears to be more straightforward. Prior to the FCD, the former article L.431-7 of the Financial Code[71] provided that debts on financial instruments could be set off if adhering to market association rules or the general terms of standard market agreements, and operations could be terminated notwithstanding the provisions of insolvency law (*i.e.* book VI of the Commercial Code). The law also envisaged that the contractual modalities of termination, valuation and set-off are enforceable against third parties instituting civil execution action. Thus, the implementation of the FCD derogations did not require drastic changes in substance. The reference to the enforceability of close-out netting provisions notwithstanding third party action was retained and the exclusion of close-out netting provisions (and not only their termination aspect) from the provisions of book VI of the Commercial Code was inserted in a new article L.431-7-2.[72] The French legislator did not deem it necessary to adapt the law to stipulate that close-out netting provisions are to take effect 'in accordance with their terms' as provided by Article 7(1) of the FCD, no doubt having considered that the recognition of the termination and set-off of financial obligations and the derogations provided are sufficient to meet this standard. Thus, the French legislator only adapted the existing close-out netting law where it might be considered in breach of the FCD but otherwise continued to resort to existing legislation to implement the FCD.

### 8.4.3 Retention of National Law Restrictions

The FCD, as stated above, permits Member States to retain two types of restrictions which may affect the recognition of close-out netting provisions. The first is stipulated in Recital (15) and permits Member States to retain restrictions or requirements on bringing into account claims, on obligations to set-off or on netting. Under this restriction Member States may for instance retain any restrictions which under national law would serve to justify on moral and equity grounds a restriction of the recognition of close-out netting provisions. The second is provided by Article 4(6) and regards the possibility to retain avoidance actions on the grounds that the valuation or realisation of assets has not been conducted in a commercially reasonable manner. The implementation of these parts of the FCD could not have produced more contrasting results that those of England and France. Whilst the substantive issues regarding any national law restrictions which could

71 As modified by Law no. 2003-706 of 1 August 2003.

72 See Ordinance No. 2005-171 of 24 February 2005 and Law No. 2005-842 of 26 July 2005. Today these derogations are contained in articles L.211-36-1, II and L.211-40 respectively of the Financial Code.

affect the role of party autonomy have been dealt with in Chapter 7.2.2, this part will comment on the influence of the legal system in the implementation of these restrictions.

The English legislator resorted to both types of restrictions when implementing the FCD. In relation to Recital (15) of the FCD, regulation 12(2) of the FCAR introduces a number of conditions in order to permit the enforceability of close-out netting provisions upon insolvency which mainly regard the lack of actual or constructive knowledge of the imminent or pending insolvency proceedings. Two sources of influence of common law may be detected in this approach. The first is the presence of morality concerns of the legislator to ensure an element of fairness in the recognition of close-out netting provisions and the privileges ensuing therefrom. The second is the influence of the mandatory rules of insolvency set-off which also impose similar requirements on the lack of actual knowledge of a pending insolvency proceeding. In relation to Article 4(6) of the FCD, certain provisions on avoidance actions on account of the fraudulent conduct of the solvent party have not been disapplied by the FCAR. It has been seen in Chapter 7.2.2 that this has been interpreted so they still apply to close-out netting arrangements. Whilst it is understandable on morality grounds that the parties should not be allowed to act fraudulently when concluding their close-out netting arrangements, the English legislator has now created a situation whereby certain provisions have been disapplied, other provisions are deemed to continue to apply as there is involved the bad faith or fraudulent intent of the parties, whereas there could be yet other provisions which have not been specifically disapplied and do not fall under the type of avoidance actions based on fraud or bad faith. In this case the parties are left with the uncertainty whether these are covered by regulation 12(1) of the FCAR. In this grey area, the parties will have to resort to interpretation rules of common law to resolve the issue, one of these being that contracts should be interpreted to meet the reasonable expectations of the parties.

The French legislator, on the other hand, has laid down general derogations from civil execution action in article L.211-36-1, II of the Financial Code and from the entire book VI of the Commercial Code dealing with insolvency proceedings (including corresponding provisions under foreign law) in article L.211-40, and did not subject them to any conditionalities. This was also the situation prior to the implementation of the FCD. Two possible influences of the civil law system to which French law belongs can help explain this situation. The first is the civil law characteristic that the law is what the legislator states it is and there is no or little debate on morality issues. This may result in less balancing of public and private interests and may lead to different expectations than would subsist in common law jurisdictions. Indeed, it has been seen in Chapter 5.4.1 that for a considerable period of time French civil law permitted trade to continue after the commencement of insolvency proceedings as this was considered beneficial for the viability of the failing business. Even the set-off of claims was permitted if arising after insolvency whilst restrictions of connexity were (and still are) imposed to allow set-off of pre-insolvency debts. In this scenario, the French legislator chose not to impose any restrictions or conditionality relating to the time when the financial obligation has arisen as foreseen in Article 8(2) of the FCD. Second, a tendency of civil law systems is for laws to be drafted as general rules which are then interpreted to apply to different situations. It will therefore be up to the courts to apply any 'mandatory' restrictions which should be read into the general derogations protecting close-out netting provisions. In this case, it would be expected that the courts would declare invalid a close-out netting provision if this has been fraudulently entered into on account of the insolvency, but it would leave uncertain the extent to which the courts are free to annul a close-out netting provision on other grounds, such as on the basis of the moment of entering into the financial obligation if fraudulent intent cannot be proved.

### 8.4.4 The US Situation

Finally, it may or may not be a coincidence that at the time EU Member States were expected to implement the FCD (and in most cases this was expected to significantly widen the scope of recognition of close-out netting provisions), the US legislator enacted BAPCPA in 2005 which arguably brought about the most wide-ranging amendments to the existing safe harbours. The possible influence lies not so much in the importation into BAPCPA of the actual drafting of the FCD, since BAPCPA amends and retains the style of drafting of the existing safe harbours, but potentially the influence lies in the fact that considering the wide scope of application of the FCD and on the other hand the narrow scope of application of the original safe harbours, the US legislator may have felt the need to revamp the safe harbours in a number of ways already foreseen in Chapter 6.3. Just to highlight a major amendment of BAPCPA, the widening of the scope of the original safe harbours included the expansion of the definitions of the various contracts covered by the safe harbours similar to the style adopted for defining a swap agreement in relation to section 560 of the Bankruptcy Code. Thus, each defined contract (*e.g.* 'securities contract', 'commodities contract', 'forward contract', 'repurchase agreement', *etc.*) was similarly defined in style to include a list of known contracts, including any other similar agreements, a combination of agreements or an option to enter into such a contract, including a master agreement and any security or credit enhancement related thereto. BACPCA also expanded the type of parties that may benefit from the safe harbour in relation to each contract and created the notion of 'financial participant' who, provided certain thresholds are met, may qualify for protection under any of the safe harbours. In one aspect BAPCPA went beyond the FCD and introduced the concept of cross-product netting incorporated in section 561 of the Bankruptcy Code. The overall impression is that the US legislator, following the enactment of the FCD in 2002, did not wish to fall behind the movement of the EU-wide strengthening of close-out netting regimes.

## 8.5 The Effect of Resolution Measures

Different sources have shaped the close-out netting regimes of the three selected jurisdictions. Thus, whilst under English law, close-out netting initially developed under party autonomy as an external source of law and relied on the rules of insolvency set-off for its legitimacy until it became necessary for the English legislator to implement the provisions of the FCD, under both French and US laws the self-regulation by market associations is made evident, *inter alia*, by the reference in their national law provisions to the rules and terms of standard agreements adopted by these market associations.[73] Further significant changes occurred to these regimes in the aftermath of the financial crisis of 2007-2009 by the adoption of bank resolution regimes by national legislators.

The impetus of these resolution regimes is arguably based on recommendations made by international regulatory organisations which, although not having the force of law, have strongly influenced national legislators to adopt resolution regimes on the basis of moral suasion. It has been seen in Chapter 3 that organisations such as the BIS, FSB and IMF have issued reports or declarations between 2010 and 2011 recommending that close-out netting provisions, collateral arrangements and early termination clauses should not operate so as to frustrate the effectiveness of resolution measures required to be taken in relation to a failing financial institution for financial stability purposes. The main recommendation is that the exercise of the respective rights under these arrangements should be temporarily delayed. These recommendations also acknowledged the need to safeguard creditors' rights so that the right balance is achieved between the protection of financial stability and the rights of creditors under private arrangements.

These recommendations have not only influenced national legislators to amend their close-out netting regimes to provide for the supremacy of resolution laws, but also financial market associations which had originally influenced the development of close-out netting regimes had to amend their master agreements to take into account the overriding importance of these national resolution regimes. Thus, ISDA, which had been instrumental in lobbying for national close-out netting regimes in the early 1990s, was constrained to amend both its Model Netting Law[74] to restrict the exercise of close-out netting rights to allow for the effectiveness of national resolution measures and to issue Resolution Stay Protocols[75] which provide for the cross-border recognition of national resolution laws in order to conform with these national resolution regimes.

73 This reflects the legal doctrine of the applicable legal systems whereby English law being a common law jurisdiction recognises party autonomy as an external source of law, whilst the French and US regimes being a civil and hybrid system respectively would rely on statutory recognition of party autonomy.

74 See ISDA 2018 Model Netting Act, section 4(j).

75 See the ISDA 2015 Universal Resolution Stay Protocol, the ISDA Resolution Stay Jurisdictional Modular Protocol & the ISDA 2018 U.S. Resolution Stay Protocol.

A major development in the EU in relation to bank resolution is the adoption of the BRRD, already discussed in Chapter 3, which seeks to harmonise the restrictions imposed on the exercise of close-out netting rights and establishes the necessary safeguards to protect those rights. Without doubt the BRRD had a significant influence on the role given to contractual freedom under the English and French netting regimes. However, it has also been seen in Chapter 7.3.2 that there are certain important differences in the implementation of the BRRD which indicate that the French legislator was more faithful than its English counterpart in such implementation. This difference could result in part from the fact that England had a bank resolution law since 2008 which was a temporary law enacted to resolve the failure of Northern Rock and which pre-dates the declarations and recommendations made by the BIS, FSB and IMF. This was replaced by the Banking Act 2009 and was later adapted to fulfil the BRRD requirements. As a result, certain modalities already applying under the former law were retained. On the contrary, the French legislator enacted the first resolution regime at the time the BRRD proposal was being discussed and the first law was in fact based on this proposal. There is a reversal of what occurred at the time the FCD was adopted when, there being no English close-out netting law in existence, the English legislator followed closely the wording of the FCD in its implementation, whilst the French legislator sought to adapt existing close-out netting legislation with the result that the terminology and style of drafting is different from that of the FCD. This goes to show that the English and French legislators were less restrained by their legal doctrine in cases where no law existed prior to the implementation of EU directives.

Taking into account the provisions of the BRRD which are deemed to represent best practice in the area of resolution measures, three types of restrictions may, generally speaking, affect the exercise of close-out netting rights. First, Article 68 of the BRRD imposes a ban on the exercise of early termination rights on the sole basis that a resolution measure has been adopted provided substantive obligations under the netting arrangement continue to be performed. Second, a temporary suspension is imposed under Article 71 on the exercise of termination rights and the performance of other obligations to enable the resolution authority to exercise resolution powers, having due regard to the effect this might have on the orderly functioning of the financial markets. These rights become immediately effective after the expiration of the suspension and even before if certain conditions concur. The third is more in the form of a safeguard and prohibits under Article 77 the partial transfer of obligations under a netting arrangement in order not to frustrate the possibility for the netting creditor to eventually be able to exercise its netting rights under the netting contract.

Considered from a general perspective, these restrictions and safeguards are found in all three selected jurisdictions so that there is indeed a global trend on the type of restrictions and general safeguards which has been arguably influenced by international regulatory bodies and the EU.

Still, national law influences were not totally eliminated, especially in cases where the national legislators had already in place national resolution measures. One noticeable difference between the three selected jurisdictions is that prior to the BRRD, the three regimes did not provide for safeguards to the netting creditors other than the general one that the partial transfer of obligations is prohibited. Following the adoption of the BRRD and the safeguards provided therein, the English and French legislators updated their laws to include these safeguards, whilst US law, which has not been influenced by the BRRD, now has less safeguards in place than the other two jurisdictions.

Distinctive approaches have been taken by the three selected jurisdictions in relation to the scope of application of the resolution measures. The English legislator retained its original approach of excluding the reorganisation and liquidation of a bank and certain investment firms, whether systemically important or not, from the scope of the Insolvency Act and regulating the resolution, administration and winding-up of these entities in the Banking Act. Arguably following the failure of Northern Rock, the English legislator deemed it necessary for financial stability purposes to regulate the failure of a bank through separate legislation and this did not change with the implementation of the BRRD. On the other hand, the BRRD has exerted a significant influence upon the French legislator which limits the application of the French resolution measures to banks and investment firms considered systemically important in terms of the BRRD. A different perspective has been adopted by the US legislator in the FDIA and OLA regimes. Both regimes regulate the recognition of close-out netting arrangements and the resolution of banks and systemically important non-bank financial institutions in similar terms, but whilst FDIA does so in case of every bank which is thus no longer subject to the provisions of the Bankruptcy Code, under OLA a determination has to be made whether a failing non-bank financial institution is deemed to be of systemic importance to be treated under the provisions of OLA instead of the Bankruptcy Code. It appears that whilst general statements of international bodies may have started the momentum for the adoption of resolution regimes, each legislator has sought to define, on the basis of the experience of national financial institutions' failures, what level of protection needs to be adopted to ensure the stability of the financial system. This is the case of the English and US legislators which have siphoned off banks and certain financial institutions from the general provisions of insolvency law, whilst the French legislator which originally adopted resolution law based on the proposal for the BRRD continued adapting this law to implement the final version of the BRRD into national law keeping the same scope of application.

A marked difference between the US regime on the one hand, and the English and French regimes on the other relates to the inclusion of safeguards to protect creditors' rights from the exercise of resolution measures. It has been noted in Chapter 7.3.2 that prior to the adoption of the BRRD, the general trend was that no safeguards were available in all three jurisdictions save for the prohibition of partial transfer of obligations related to a netting contract. Following the adoption of the BRRD, this remains the approach under US law which therefore continues to be influenced by the strict financial stability purpose that resolution measures are meant to protect, whilst, as was expected, both the English and French legislators have adapted their resolution regimes to implement the BRRD safeguards. Overall it has been noted in Chapter 7 that the US resolution regimes are less favourable to the netting creditor both on account of the fact that US law at times imposes bans, as opposed to temporary suspensions, from the exercise of early termination rights and it offers less safeguards to netting creditors. One may here detect a similar attitude in the approach taken by Congress in the extensions to the safe harbours brought by BAPCPA in 2005, where, arguably on account of the pressure exerted by the industry, few, if any, restrictions were imposed on the recognition of close-out netting provisions. Similarly (but in the opposite direction), following the declarations by international regulatory bodies on the effectiveness of resolution measures, restrictions imposed by Congress on close-out netting by the resolution regime were not balanced out sufficiently by safeguards to protect close-out netting rights when this is justified. Thus, the tendency of Congress to be market-driven is consistent in the whole process.

The balance sought to be achieved by the BRRD is the result of negotiations between the EU Member States which could involve also the protection of national interests. But once adopted, it is expected to be implemented in a harmonised manner across the EU. Considering the English and French regimes, whilst there is adequate harmonisation in the parts of the law implementing the restrictions and safeguards concerning early termination rights and the prohibition of partial transfers, in relation to the bail-in provision the English legislator opted to retain two national law features not conforming with the BRRD provisions, namely not to close out the agreement when exercising bail-in[76] and to calculate the net amount either in accordance with the netting agreement or in accordance with the special bail-in provision where the valuation is made by the Bank of England.[77] It is doubtful whether these features are aligned with the requirements of the BRRD. Article 49(2) of the BRRD provides that resolution authorities 'shall exercise the write-down and conversion powers in relation to a liability arising from a derivative only upon or after closing-out the derivatives' and Article 49(3) of the BRRD provides that where derivative transactions are subject to a netting agreement the valuation of the transactions is to be made 'on a net basis in accordance with the terms of the agreement'. Since these provisions are expressed in mandatory terms, it would appear that the

76 In relation to this aspect, it has been noted in Chapter 4.2 that the definition of 'netting arrangements' in both sections 48(1)(d) and 48P of the Banking Act does not contemplate the closing out of transactions but simply the conversion of a number of claims or obligations into a net claim or obligation.

77 See in this respect HM TREASURY 2017 SRR Code of Conduct, paras 8.28-8.32.

English legislator is not given a choice to implement differently. However, it may also be recalled that the FCD permits national legislators to impose restrictions on the valuation of collateral and transactions in its Article 4(6) so it could be argued that the BRRD, in this sense, may be read in the light of Article 4(6) of the FCD and permit any national law restrictions on valuation. The approach adopted by the English legislator may be best explained by the fact that having already in place a resolution regime prior to the implementation of the BRRD must have resulted in certain discrepancies arising under the former law which were not properly addressed upon implementation of the BRRD. Another trait which has not been changed by the English legislator is the application of the resolution regime under the Banking Act to all banks, and not solely systemically important banks as foreseen by Article 1(1) of the BRRD. These are therefore instances where matters which are deemed to be harmonised under EU law continue to apply differently in the Member States not because an option has been given, but because national law continues to determine certain aspects notwithstanding the clear provisions of the EU Directive.

Just as the development of close-out netting regimes was initially put in motion by the proliferation of the derivatives industry and the issuance of reports such as the Lamfalussy Report which highlighted the need to have legal certainty under national law for the enforcement of close-out netting provisions, in a similar manner the financial crisis and the accompanying declarations of international regulatory bodies triggered the adoption of national resolution laws where it became necessary for financial stability purposes to restrict party autonomy to allow national authorities to deal with failing financial institutions. This resulted not only in the enactment of national resolution measures which placed restrictions on the exercise of close-out netting rights, but also led international market associations such as ISDA to amend their market agreements to give recognition to national resolution measures.

Arguably, on account of the influence of the aforesaid international declarations, the restrictions imposed on the exercise of close-out netting rights are relatively similar in the three selected jurisdictions and may indicate a global standard of restrictions on the exercise of close-out netting rights, albeit with slight variations in the personal scope of application. The BRRD has introduced a number of safeguards which may not have been included in the national regimes so that left on their own EU national legislators presumably would not have included them, as is currently the situation in the US. US netting law is arguably still market-driven so that the tendency of Congress is to bow to the pressure of the market without taking into account, to a greater or lesser degree, the balancing of rights in doing so. On the other hand, there is a limited reversal of the approaches taken by the English and French legislators. Thus, whilst the English legislator adopted more faithfully the FCD provisions into the FCAR notwithstanding the mandatory insolvency set-off rules, it retained traits of the original resolution regime when it adopted the BRRD and may therefore have retained its own characteristics, evidenced mainly in the bail-in provision. On the other hand, whilst the French legislator adapted its existing netting law to transpose the FCD and in the process retained the style of drafting of its original netting law, it was prepared to transpose more faithfully the provisions of the BRRD possibly since no resolution law was in existence before the BRRD proposal was issued.

## 8.6 Final Conclusions

This research has sought to analyse how a relatively modern risk-mitigating concept such as close-out netting whose development was driven by the financial markets has been implemented in the English, French and US jurisdictions which hail from different or hybrid legal systems. The analysis considered the main research question whether the legal systems of England, France and the US influenced the recognition in these jurisdictions of the concept of insolvency close-out netting as developed by the market. Three main 'yardsticks' have been relied upon to gauge this process. First, the development of close-out netting has been compared to that of set-off which aims to achieve the same economic result and as a long-standing concept is expected to give a good indication of the philosophy and pro-creditor or pro-debtor tendencies of the legal system to which it pertains. This research has therefore analysed whether this philosophy and precepts of the applicable legal system have influenced the development of insolvency close-out netting or whether there has been a severance from such influence. Second, consideration has been given to whether mandatory provisions of insolvency law continue to restrict the full recognition given to close-out netting provisions and whether the legislator was pursuing a particular state insolvency goal when developing the close-out netting regime. Third, the more recent adoption of resolution regimes and the pursuit of financial stability objectives has resulted in relatively similar restrictions imposed on the exercise of close-out netting rights as already developed under the national regimes. In addition, consideration was also given to the influence of the EU's FCD and BRRD on the development of close-out netting in England and France which could also have constituted a deviation from the precepts of their legal systems.

The interplay between the influences of the legal system and the *lex mercatoria* is evident in varying degrees in all three selected regimes. It is possibly under English law that the development of close-out netting was mostly influenced by the applicable legal system, *i.e* by common law. At a time when various legislators were enacting their new close-out netting regimes in the early 1990s in order to bring the required legal certainty to the enforceability of close-out netting provisions, the English legislator continued to give recognition to close-out netting under the rules of insolvency set-off and any deviation from such rules and thus any contractual enhancement to such rules could be considered by the courts as a means of contracting out of insolvency law. In the light of this legal uncertainty and in view of the approach taken by the legislator to continue to rely on existing common law sources to give recognition to close-out netting provisions, the Financial Law Panel deemed it necessary to issue a Guidance Note in 1993 to reinforce this legal certainty. Although the implementation of the FCD into English law solved the uncertainties surrounding the enforceability of close-out netting provisions, it has not changed the legislator's approach that close-out netting already worked under English law. This is evident from the statements made in the FCAR consultation document cited in this chapter and from the fact that the legislator did not take the opportunity to provide for an *ad hoc* close-out netting regime but instead chose to insert provisions granting it recognition in a legal framework whose scope of application is primarily intended to regulate financial collateral arrangements. The assumption can therefore be made that, had it not been for the obligation to implement the FCD, the English legislator would have recognised close-out netting provisions only within the confines of applicable common law and provided insolvency set-off and insolvency rules were adhered to.

The French and US legislators have also relied on the concept of set-off to construe their close-out netting regimes, but in both cases the legislator resorted to the rules of the market to regulate the setting off of claims under close-out netting. As a result, rather than resort to their respective legal systems as the basis for formulating the type of recognition to be granted to insolvency close-out netting, the French and US legislators were ready to rely on market practice and industry rules to regulate the recognition of close-out netting even though their respective legal systems (especially the civil law system of France) are typically prescriptive and do not readily rely on market practices as a primary source of law. The recognition of these practices was subsequently enshrined in the law in order to avoid doubt as to their status under the law. In fact, the French and US legislators have been more willing to facilitate the industry and did not feel constrained by the rules of set-off or insolvency law in order to do so. It is to be noted that under both jurisdictions set-off is a voluntary act and this approach taken to close-out netting confirms the statements made by Dalhuisen quoted in Chapter 7.2.1 that it is more probable that legislators will allow contractual enhancements to set-off in jurisdictions where set-off is subject to invocation or notification. Both jurisdictions have amended their close-out netting laws mainly to extend the material scope of application to cover more markets but have done so in different ways. Whereas the French legislator has sought to unify the close-out netting regime in keeping with the codification trend of a civil law system and even kept it separate from the financial collateral regime when implementing the FCD so that it continues to serve its original purpose of an indemnification mechanism, the US legislator retained and amended the existing safe harbours and sought to cover any uncertainties by enacting FDICIA, thus creating an overlap in the regulation of close-out netting. Besides the influence of the market to increase the scope of application of these two close-out netting regimes, there is also the fact that as a civil and hybrid law jurisdiction respectively, party autonomy may not be safely relied upon as an external source of law and the legislator is required to grant statutory recognition for a close-out netting provision to be deemed valid.

Another issue analysed is whether the debate on morality justification typically associated with common law jurisdictions could have influenced the development of the national close-out netting regimes. Also in this case, English law has been mostly influenced by the common law perspective on fairness and morality, followed by US law. Morality debates have surrounded the privileges given to set-off under both English and US laws since the fairness and justification grounds on which they are based may have been taken more from the point of view of the parties involved in the bilateral relations rather than the wider body of creditors. But whilst English law developed a flexible concept of insolvency set-off which could be resorted to for the recognition of close-out netting provisions prior to the FCAR, the US legislator continued to subject the exercise of set-off to the insolvency principles and to court intervention. Whilst significant debate on the extent of the privileges given to netting creditors and its effect on the *pari passu* principle arose in both jurisdictions, it seems that morality issues only minimally influenced the development of their close-out netting regimes. Thus, the FCAR imposes a 'moral' condition related to the actual or constructive knowledge of the pending insolvency and it is implied that avoidance actions continue to apply if fraudulent intent can be proved. Although no explicit condition on actual or constructive knowledge is imposed under the US safe harbours, it is understood that avoidance provisions also continue to apply. It can be assumed that the importance of the workability of this concept for the market was a check on legislators not to unduly restrict its recognition.

It does not seem that morality issues affected the development of close-out netting in France and this is typical of a civil law jurisdiction. Both set-off and close-out netting were given a functional purpose which is fulfilled by their respective regimes. Set-off is a method of extinguishment of obligations and continues to be regulated as such upon insolvency so that the legislator did not feel the need to create a separate concept of insolvency set-off but imposed general conditions such as the connexity of claims to permit the setting off of claims upon insolvency. Close-out netting, on the other hand, was developed to fulfil the purpose of an indemnification mechanism for the financial markets. The fulfilment of this purpose may have encouraged the legislator to facilitate the market and enlarge the material scope of the close-out netting regime in order to capture more financial market agreements, even though the implementation of the FCD may have further enlarged the scope beyond this original purpose. That issues of fairness or morality do not seem to have been of special concern is also seen in the unconditional derogations granted for the protection of close-out netting provisions from insolvency law and third-party civil action so that it is up to the courts to interpret these derogations to exclude action taken with fraudulent intent.

Although it is generally stated that common law jurisdictions have a tendency to be more pro-creditor and this is evidenced in particular in the recognition given to pre-insolvency contractual entitlements in these jurisdictions, there seems to be a reversal of the pro-debtor and pro-creditor approaches when considering the three selected close-out netting regimes. The English regime is perhaps the most limited in material scope since it is restricted to close-out netting provisions forming part of a financial collateral arrangement and it is also the regime imposing most conditionality. The French and US regimes are more market-driven and thus focused on the expansion of the material scope to cover more sectors of the financial markets. This approach may be difficult to reconcile with the pro-debtor tendency of their respective insolvency regimes and may be explained by the intention, expressed or otherwise, of the state to remain competitive on the market and is an indication that when faced with this state goal, less influence is exerted by the legal system on the recognition of close-out netting. The approach taken under the French and US regimes appears to confirm the comments made by Dalhuisen and Goode cited in part 1 of this chapter that notwithstanding that the *lex mercatoria* may traditionally be considered less acceptable in civil (and hybrid) law jurisdictions, however modern legislators would be willing to adapt their laws to meet the needs of international commerce.

Finally, the adoption of resolution regimes for the protection of financial stability has brought about a standardisation of the restrictions imposed on the enforcement of close-out netting provisions which saw the influence of recommendations of international regulatory bodies take over from that of the private industry. In the aftermath of the financial crisis and at the time these international regulatory bodies issued their recommendations, it is clearly noticeable that the level of restrictions imposed in the three jurisdictions on the exercise of close-out netting rights was virtually identical. Following the implementation of the EU's BRRD, the same restrictions remained but more safeguards were introduced to protect the close-out netting mechanism, albeit with differences in implementation into the English and French regimes. In this case it has been seen that English law, having a pre-existing bank resolution regime, has continued to be influenced by pre-existing law in the implementation of the close-out netting provisions of the BRRD. French law, having no pre-existing bank resolution law, has implemented the BRRD more faithfully. US law continues to develop its own, albeit similar, resolution regime which has nowadays resulted in a more restrictive exercise of close-out netting rights than applicable under the English and French resolution regimes. However, the general similarity in the type of restrictions imposed on the exercise of close-out netting rights in a resolution situation can only indicate that the pursuit of the public interest of maintaining financial stability has significantly influenced this and serves to underline that the pursuit of a public interest requires an international response for its effectiveness.

All in all, in reply to the question whether the legal systems of England, France and the US have influenced the recognition of insolvency close-out netting, the reply is yes for all three jurisdictions, but with varying degrees. It has been seen that English common law has exerted the most influence on such recognition whilst the French regime continues to be the one most ready to develop according to market practices notwithstanding the precepts of civil law. Although it may be considered contrary to expectations that a civil law jurisdiction such as France is more accommodating to market practices than a common law jurisdiction such as England, one may here notice the same trend repeating itself in relation to the historical acceptance of set-off as a market practice which was readily accepted in France but met with resistance in England. US law, on the other hand, continues to take a more balanced approach in the recognition of close-out netting as expected of the hybrid nature of the US legal system and may be said to continue to closely follow the European approach which in the recognition of close-out netting seems to be more liberal than the US. Even here history repeats itself since also with the advent of set-off, the US judges were mostly influenced by English doctrine and judgments in the formulation of their set-off rules.

*Final Statements*

A number of short statements may be made in relation to the final conclusions reached in this research.

1. First, close-out netting is considered in this thesis as a stand-alone concept whose scope of application may extend beyond the confines of the financial markets.
2. Second, contractual enhancements of close-out netting based on set-off are more probable where set-off is subject to invocation or notification, as opposed to when it is mandatory or self-executory.
3. Third, notwithstanding the traditional distinction between common and civil law jurisdictions as being pro-creditor and pro-debtor respectively, this research shows that such method of assessing a country's legal system is too generic. In the research it is demonstrated that competitiveness considerations may have resulted in civil law jurisdictions such as France being more amenable to change their laws to adapt to market developments.
4. Fourth, the development of close-out netting in a common law jurisdiction such as England, and to a lesser extent the US, morality and fairness considerations appear to have influenced the debate and development of close-out netting, whilst in a civil law jurisdiction such as France the dominant consideration appears to be the fulfilment of a functional purpose.
5. Fifth, and finally, the international dimension applicable to bank resolution regimes based on the pursuit of public interests such as financial stability and the protection against systemic risk has brought about a level of uniformisation in the type of restrictions imposed on the exercise of close-out netting rights.