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

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Summary

Introduction

This research considers the development of the concept of insolvency close-out netting under the laws of England (*i.e.* England and Wales), France and the US. Close-out netting developed as a financial market risk mitigation tool on the basis of the *lex mercatoria* permitting the calculation of risks on a net, rather than gross, basis. The close-out netting process, when it takes effect in accordance with its terms in insolvency, has provided financial market participants with a substantial measure of self-help in enforcing their claims against an insolvent counterparty.

The reference to the development of close-out netting provisions under the *lex mercatoria* as used in this research refers to the way in which the close-out netting developed under sources of soft law. Resort to close-out netting provisions initially proliferated through the use of standard master agreements developed by private market associations, both on a national and global scale, mainly in the derivatives and repurchase markets. The need for legal certainty in the enforceability of close-out netting provisions was underlined in declarations issued by international regulatory bodies with the result that national legislators worldwide started to enact law to grant recognition to close-out netting provisions. An important milestone in the process of national statutory recognition of close-out netting has been the adoption of the EU's Financial Collateral Directive which imposes upon EU Member States the general obligation to base their recognition of close-out netting provisions on the standard of 'in accordance with their terms'.

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

The main question to be addressed in this research is the following:

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

Thus, the topic of close-out netting in insolvency under present English, French and US laws is approached from a historic-theoretical perspective. The reply to this research question is based on preliminary replies provided to three sub-questions which are answered mainly under the national law and comparative law chapters, namely (i) whether the development of the concept of close-out netting in these jurisdictions has been influenced by the respective jurisdiction's set-off rules or whether close-out netting has developed as an autonomous concept, (ii) whether the recognition given to close-out netting 'in accordance with its terms' has been affected by the norms and rules of the jurisdictions' national insolvency laws and state insolvency goals (and, if so, in what manner), and (iii) whether, following the global financial crisis of 2008 – 2009, a convergence can be noted in the restrictions imposed on the recognition of close-out netting provisions under these jurisdictions' national resolution regimes (and, if so, in what manner).

Part I

This research is divided into three parts and eight chapters. Part I contains the first three chapters of this research and introduces the main concepts or fields of law on which this research is based, namely the concept of close-out netting, its relationship with set-off and insolvency laws and resolution regimes, and the milestones of the development of close-out netting under the *lex mercatoria*. These first three chapters provide a theoretical overview of the main conceptual elements used in this research and indicates how they interact with each other.

In more detail, Chapter 1 describes the forms of netting developed by the financial markets to serve as a risk mitigation device. Although netting techniques bear distinctive forms, the economic outcome is always the same, *i.e.* the reduction of multiple exposures into one net exposure. This chapter also describes the advantages and disadvantages of close-out netting which may have influenced the level of recognition granted by national legislators, in particular in relation to the application of set-off and insolvency laws. A major influence on the recognition given to close-out netting provisions regards the pursuit of financial stability goals and the establishment of bank resolution regimes which resulted in the introduction of a number of restrictions imposed on the enforcement of close-out netting provisions to permit the exercise of resolution measures in relation to systemically important financial institutions. This chapter also examines the constitutive elements of close-out netting to enable a comparison to be made with the analogous concept of set-off. It refers to the three-step

process leading to the close-out netting concept, consisting of the termination of outstanding obligations, their valuation and the determination of a net balance. These diverse ways in which these steps can feature in a close-out netting provision is illustrated by an analysis of the close-out netting provisions of the 2002 ISDA Master Agreement and the 2011 Global Master Repurchase Agreement. Chapter 1 further provides a historical overview of the reception of set-off, itself initially developed by the commercial society, in the three selected jurisdictions. It has been seen that whilst the development of set-off under French law was strongly influenced by the Roman law notion of *compensatio,* in both the English and US jurisdictions the reception of set-off was inspired by considerations of natural justice and efficacy of dealing with separate claims in one action. The purpose of this historical overview is to determine in Chapter 8 whether the philosophical thinking of national legislators of the three selected jurisdictions in the acceptance of the set-off concept still underpins the statutory recognition of close-out netting.

Chapter 2 analyses the interaction between close-out netting provisions on the one hand, and insolvency and resolution laws on the other. Insolvency law is typically mandatory law, reflecting public policy so that the enforceability of close-out netting provisions requires a carve-out from certain insolvency law principles in order to be effective. Amongst these are the principles of the prohibition of termination of transactions and the individual pursuit of creditor claims (the 'stay'), the repudiation of unfavourable contracts ('cherry-picking') and avoidance provisions where transactions are set aside or avoided when concluded during a suspect period on the assumption that there is an unjustified preference to some creditors. The end result of these derogations is the non-enforceability of the *pari passu* principle to close-out netting provisions. The special position of credit institutions and investment firms under resolution regimes is also considered in this chapter where prudential regulation and resolution are driven by financial stability considerations. Resolution regimes have brought about a reconsideration of the extent of recognition granted to close-out netting provisions and the introduction of certain restrictions such as the imposition of a temporary stay on the exercise of private termination rights to allow for the orderly resolution of these entities.

Chapter 3 considers the sources which are deemed in this research to have established a *lex mercatoria* in relation to the development of close-out netting as a market tool. Two main sources have been identified, namely (i) the recommendations and declarations made by international regulatory bodies on the need for certainty of the legal soundness of close-out netting provisions for the stability of financial systems and (ii) the standard market documentation or agreements of private global market associations, in particular in the derivatives industry, which depend on the enforceability of their close-out netting provisions for the growth of their industry. Chapter 3 enumerates and explains these sources, amongst which are the reports of public international bodies such as the Lamfalussy Report of the

Committee on Interbank Netting Schemes of the BIS (1990), the Giovannini Report (2001), the World Bank Principles for Effective Creditor Rights and Insolvency Systems (2001) and the United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law (2004). Foremost among the sources concerning private association efforts to promote the global statutory recognition of close-out netting provisions is ISDA with its master agreements and its ISDA Model Netting Law. Prior to the financial crisis, both sources were advocating the protection of close-out netting provisions in accordance with their terms and were generally in agreement that insolvency law should not hinder the enforceability of close-out netting provisions. Following the financial crisis, the international regulatory bodies took the lead in issuing declarations on the need to curb the favourable treatment given to close-out netting provisions upon insolvency in relation to failing bank institutions to enable resolution authorities to effectively exercise bank resolution measures. EU law has been designated as a third source of the *lex mercatoria.* Two particular legal acts have been singled out as having influenced the substantive nature of close-out netting regulation, namely the Financial Collateral Directive and the Bank Recovery and Resolution Directive. Chapter 3 assesses the impact of these two Directives in the area of close-out netting which is foremost a primary (binding) source of law for EU Member States but which may have exerted influence beyond the EU for other countries who wish to remain competitive in the market and may thus be considered as a special *lex mercatoria*.

Part II

In Part II on the national close-out netting regimes, each of Chapters 4, 5 and 6 analyses the extent of recognition granted to insolvency close-out netting provisions under the laws of England, France and the US, respectively. These chapters provide for each of these jurisdictions (i) a brief overview of the national insolvency proceedings, bank resolution laws and the applicable laws which grant recognition to insolvency close-out netting, (ii) a comparative analysis of the constitutive elements of the concepts of close-out netting and insolvency set-off, (iii) an examination of the way in which close-out netting developed and how it was affected by the promulgation of bank resolution regimes and (iv) a consideration of the rationale and principles forming the basis of national insolvency law and the congruence of derogations granted in favour of close-out netting with any public policy or insolvency goal established by the State. In this Part II, sub-questions (i) to (iii) referred to above in relation to the main question are analysed from the point of view of the national law of the three selected jurisdictions and the following preliminary conclusions were drawn for each of these sub-questions in preparation for the comparative analysis carried out in Chapter 7:

In relation to English law, (i) the influence of insolvency set-off rules on the recognition granted to close-out netting depends on the scope of appli-

cation of the close-out netting provision. Those provisions falling within the scope of application of the Financial Collateral Arrangement (No. 2) Regulations 2003 (FCAR) are given recognition 'in accordance with their terms' and are not affected by insolvency set-off rules. On the other hand, close-out netting provisions not falling within the scope of the FCAR may need to be tailored on the mandatory rules of insolvency set-off in order not to be impugned in court as an attempt by the parties to contract out of insolvency law. (ii) English insolvency law generally enforces pre-insolvency contractual entitlements and recognises specified groups of preferential interests so that the preference given to close-out netting is aligned with English insolvency law principles. However, the widened scope of the application of the close-out netting regimes to cover agreements between corporates has raised the debate by English authors on the proportionality of this preference *vis-à-vis* the *pari passu* principle. Such preferential treatment may be explained in the light of insolvency goals set by the State which favour the competitiveness of the market. (iii) The provisions of the English Banking Act 2009 have introduced restrictions on the contractual freedom of the parties insofar as concerns close-out netting arrangements to ensure the effective exercise of resolution measures, but this is done with due consideration given to the fact that the rights of netting creditors should not be unduly restricted and safeguards have been put in place.

In relation to French law, (i) whilst the reference to set-off in article L.211-36-1 of the Monetary and Financial Code (the Financial Code) appears to be central to the regulation of close-out netting, this has not restricted the pace for the contractual enhancement on which the close-out netting concept is based. Beyond the requirement of reciprocity, the type of contractual enhancements permitted by French law for the recognition of close-out netting provisions indicates that set-off rules have not, generally speaking, influenced the more recent development or the interpretation of close-out netting rules. (ii) It has been noted that the French legislator granted broad derogations from insolvency law and third-party action under articles L.211-40 and L.211-36-1, II respectively of the Financial Code. However, other laws not captured by these derogations such as the law on conservatory measures adopted by the *Autorité de contrôle prudential et de resolution* under article L.612-33 of the Financial Code continue to apply. Thus, whilst the French legislator was liberal in the derogations granted under two specific regimes (*i.e.* insolvency law and civil execution action), no consideration seems to have been given to other regimes which could affect the recognition granted to close-out netting. (iii) The reply to the third sub-question is that the enactment of resolution law has also brought some modifications in the enforcement of close-out netting provisions which are closely similar to those imposed under English law. This is not a surprise considering that both the French and English regimes had to adhere to the EU's Bank Recovery and Resolution Directive. A number of interests are balanced out and safeguards are introduced, but the close-out netting mechanism itself remains intact so that an amount of protection has been

given even in the ambit of public policy regimes such as the resolution regime.

In relation to US law, (i) it is deemed that the right of close-out netting protected under the safe harbours has no ties or links to the concept or rules of ordinary set-off but has been created as a separate concept based on the notion of protection of contractual rights in relation to financial contracts, possibly to suit the requirements of the derivatives market industry. Thus, the exercise of contractual close-out netting rights under the safe harbours is exonerated from observance of these principles or restrictions which still apply in respect of ordinary set-off under the Bankruptcy Code, save when exercised in bad faith. (ii) The safe harbours are an exception to the traditional rationale of US bankruptcy law which is aimed towards the discharge of the debtor and the preservation of the going-concern value of the enterprise. It has been found difficult to reconcile the protection given to close-out netting under the safe harbours with the pursuit of a particular goal or public policy followed by Congress which, except in relation to the application of resolution regimes, has chosen to give virtually full protection to close-out netting from the application of insolvency law principles. (iii) The financial crisis in the US heralded new considerations of systemic risk and led to the adoption of two resolution regimes, first the Federal Deposit Insurance Act (FDIA) for insured banks and subsequently the regime under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the OLA regime) for systemically important non-bank financial institutions. A primary goal of these resolution regimes is to promote the stability of the financial system. With the exception of the bail-in regime, the restrictions imposed by these regimes are reminiscent of those found under the English and French regimes.

Part III

In Part III conclusive replies are provided in Chapter 7 to the three sub-questions based on the preliminary conclusions reached in the national law chapters. These replies are then used in Chapter 8 to reply to the main research question.

In more detail, Chapter 7 undertakes a comparative analysis of all the aspects considered in Chapters 4 to 6 in order to establish trends and approaches taken by legislators in formulating their close-out netting regimes. A preliminary issue analysed is whether the concept of close-out netting is a uniform concept under the three regimes in a way that permits comparing it under the laws of the three selected jurisdictions. First, a comparative assessment is made whether and how the three-step process, comprising the rights of (i) termination, (ii) valuation and (iii) netting, which make up the close-out netting mechanism have been incorporated in the laws of the selected regimes. Second, the personal and material scope of application of national close-out netting regimes is analysed on a compara-

tive basis in order to establish whether it can be said that at its core the close-out netting mechanism is restricted to the financial markets.

Having established that close-out netting has indeed developed as a stand-alone concept which can be the subject of comparative analysis and that all three jurisdictions widened its material or personal scope of application beyond the confines of the financial markets, Chapter 7 continues with a comparative analysis of the preliminary conclusions to the three sub-questions reached in the national law chapters. In relation to the first sub-question, the analysis focused on whether close-out netting evolved as a contractual enhancement of set-off (or not) and whether the rules governing set-off in any way still apply or shape the application of close-out netting. Under this part it has been found that the influence of set-off rules on the development of close-out netting is mostly present under English law which continued to influence the recognition of close-out netting provisions until the enactment of the FCAR. Although close-out netting under French law was built on the existing concepts of termination and set-off, the numerous occasions in which the French legislator has amended and finetuned the close-out netting regime indicates that from an early stage close-out netting developed as a separate stand-alone concept providing compensation against financial loss which was not influenced by set-off requirements. The link between ordinary set-off and close-out netting is mostly severed under US law. Indeed, the protection of contractual freedom of close-out netting under the safe harbours was recognised from the start and was based on protection from any stay, avoidance or court and administrative orders issued under the Bankruptcy Code.

In relation to the second sub-question, the comparative analysis considers whether the recognition given to close-out netting provisions is meant to serve declared or implied State insolvency goals. This is achieved in the first part by analysing whether a strategic decision was taken by the legislator or, where applicable, by the courts to link the special treatment given to close-out netting under insolvency law to the attainment of a public policy. In relation to English law, it has been seen that on account of its congruence with pre-insolvency contractual entitlements and its compatibility with a number of English law axioms, the recognition of close-out netting under the FCAR does not seem to have been based on any particular State insolvency goal other than the general goal of the preservation of pre-insolvency contractual rights. French law is considered the most liberal in relation to the influence of insolvency law principles given that there is a full and unconditional exemption for close-out netting from insolvency law. An assumption has been made in Chapter 7 that following the harmonisation of various aspects of the European single market, the opportunity was taken by the French legislator to focus on the competitiveness of the French market. Although the US safe harbours were originally based on the goal of protecting against systemic risk, the wide scope of application of the safe harbours was difficult to justify on these grounds. This led to debates on the path dependence theory in terms of which each new expansion of the safe

harbours was used to justify further expansions. An assumption has been made that this trend may have been influenced by the lobbying pressure of the market.

In relation to the third sub-question, the comparative analysis focuses on the effect of resolution regimes on close-out netting in the pursuit of the goal of financial stability. A significant level of convergence has been noted in the resolution regimes of the three selected jurisdictions insofar as concerns the type of restrictions imposed on the exercise of close-out netting rights. On account of the implementation of the EU's Bank Recovery and Resolution Directive, more similarities have resulted in the English and French regimes. However, since the English regime predates the BRRD more restrictions have been imposed by English law when compared to French law which opted for the most favourable options to the netting creditor. US law has arguably adopted a more pronounced restrictive approach than the other two jurisdictions where more powers have been given to the resolution authorities to protect the exercise of resolution measures with less corresponding safeguards to creditors.

The comparative analysis of Chapter 7 serves to delineate the characteristics of the national close-out netting regimes of the three selected jurisdictions which may not have been possible if each were considered on its own. This analysis is used in Chapter 8 to draw conclusions on the influence of the legal systems of the three selected jurisdictions on the recognition granted to close-out netting provisions in reply to the main research question. The interplay between the influences of the legal system and the *lex mercatoria* is evident in varying degrees in all three selected regimes. It has been seen that had it not been for the obligation to implement the EU's Financial Collateral Directive, the English legislator would have recognised close-out netting 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 (rather than the rules of ordinary set-off) to regulate the setting off of claims under close-out netting. Since their respective legal systems are typically prescriptive and do not readily rely on market practices as a primary source of law, in both these jurisdictions the recognition of these practices was subsequently enshrined in the law in order to avoid doubt as to their status at law. An argument is also made that it may not be a coincidence that the US legislator enacted the most wide-ranging amendments to the safe harbours shortly after the Financial Collateral Directive was enacted which may give the overall impression that the US legislator did not wish to fall behind the movement of the EU-wide strengthening of close-out netting regimes.

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. Morality debates have surrounded the privileges given to set-off under both English and

US laws and whilst it seems that significant debate on the extent of the privileges given to netting creditors and its effect on the *pari passu* principles arose in both jurisdictions, morality issues only minimally influenced the development of their close-out netting regimes. It does not seem that morality issues affected at all the development of close-out netting in France and this is deemed typical of a civil law jurisdiction. Both set-off and close-out netting were given a functional purpose (*i.e.* as a method of payment and as a market indemnification mechanism, respectively) which is fulfilled by their respective regimes. That issues of fairness and morality do not seem to have been of special concern under French law is also seen in the unconditional derogations granted from insolvency law and third-party civil action.

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 entitlement 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. This indicates that when faced with this particular state goal, less influence is exerted by the legal system on the recognition of close-out netting.

The adoption of resolution regimes for the protection of financial stability has brought 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 are virtually identical and this in pursuit of the public interest of maintaining financial stability which requires an international response for its effectiveness. Whilst the English and French regimes have been influenced by the implementation of the EU's Bank Recovery and Resolution Directive, English law, having a pre-existing bank resolution regime, 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, implemented the BRRD more faithfully. US law continues to develop its own, albeit similar, resolution regime which has nowadays resulted in a relatively more restricted exercise of close-out netting rights.

Conclusion

Thus, in reply to the main research question whether the legal system 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. The US legal system, being a hybrid system, continues to exert a more balanced influence.