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Draft Principles regarding the enforceability of close-out netting provisions

COMMENTS

RECEIVED BY UNIDROIT IN FRENCH

(submitted by Governments and Organisations)

INTRODUCTION

The UNIDROIT Secretariat has invited the Governments of its Member States as well as Regional Economic Integration Organisations, Intergovernmental Organisations and International Non-Governmental Organisations to formulate comments on the text of the UNIDROIT Draft Principles regarding the enforceability of close-out netting provisions (C.G.E./Netting/1/W.P. 2 and Addendum) for consideration by the Committee of Governmental Experts on the enforceability of close-out netting provisions at its first session from 1 to 5 October 2012.

As of the morning of 14 September 2012 the UNIDROIT Secretariat has received comments in French language on the Draft Principles from:

- the Government of France.

These comments are reproduced hereunder.

COMMENTS SUBMITTED BY MEMBER STATES

France

General remarks

1. The UNIDROIT Study Group developed draft Principles on the enforceability of close-out netting provisions in the course of three sessions (April, September 2011, and February 2012). The UNIDROIT Governing Council, at its 91st session, took note of the progress made by the Study Group and endorsed the proposal of the Secretariat to convene a Committee of Governmental Experts to consider and finalise the draft Principles.

2. The annotated draft agenda envisages the consideration, first, of draft Principles 1 to 8, which relate to the harmonisation of substantive law, and, second, of draft Principle 9, which deals with private international law questions. We believe that the presence of a **conflicts-of law provision (draft Principle 9) in a UNIDROIT text is not natural** and relates, rather, to the competence of the Hague Conference on Private International Law. It would be important to **clarify UNIDROIT's competence** before engaging in a discussion of draft Principle 9.

3. The protection of close-out netting provisions, which entails the adoption of **rules that derogate from the law of collective insolvency procedures, can only be justified by the need to prevent systemic risk**. The draft UNIDROIT Principles, in particular the scope of application *ratione personae* and *ratione materiae*, should therefore be defined in the light of this sole criterion, and not according to a field of application that is "as broad as possible". It should be recalled, indeed, that the protection of close-out netting provisions requires the introduction in domestic legal systems of provisions that derogate considerably from the ordinary law, so as to prevent enforcement procedures (*e.g.*, the possibility for the judge to order the attachment of debts to the benefit of a third party) and above all, the law governing collective insolvency procedures do not become an obstacle to enforcing the close-out netting mechanism. The technique of close-out netting turns out *de facto* to privilege one category of creditors (those that benefit from close-out netting provisions) vis-à-vis other creditors notwithstanding the ranking of creditors established by the legislator in the general interest ("privileged creditors" such as States and employees), to the detriment of the authorities in charge of the collective proceedings faced with fdwindling assets and with the termination of contracts without their consent. This is why **only systemic risk may justify the adoption of provisions that so significantly derogate** from the ordinary regime established by the legislator.

4. By the same token, it is indispensable that the Principles **ensure the effectiveness of (bank) crisis resolution measures, in particular the power of resolution authorities to suspend close-out netting provisions**. It would indeed be inconceivable for the UNIDROIT Principles to guarantee the effectiveness of close-out netting provisions to the detriment of resolution measures intended to ensure international financial stability. This is why particular attention should be paid to the drafting of an interplay between Principles 7 and 8.

5. Lastly, the **French translation is inadequate** in some instances: it is very often impossible to literally translate Anglo-Saxon concepts that do not correspond to the legal concepts of many of the systems inspired by the French Civil Code. We propose other translations which are those more often used by such systems:

– the concept of "**close-out netting**" was translated as "*compensation avec déchéance du terme*". However, this expression reverses the chronology of the operation: the resiliation precedes the netting of the obligations that became due as a result of that resiliation. It would therefore be incorrect to use **the expression "*compensation avec déchéance du terme*" which should be replaced by the expression "*resiliation–compensation*".** This expression would enable the chronology of the procedure to be re-established;

– the concept of "*rachat*" (paras. 3, 51, 55, 60, 61, 67) does not correspond to any legal category in French law: the French equivalent covers both the expression "*vente à réméré*" (which corresponds to the English expression "by-and-sell agreements") and that of "*pensions sur instruments financiers*" (corresponding to the English expression "re-purchase agreements").

Remarks on Principles 2 and 3 relating to "eligible party" and "eligible obligation"

6. These Principles deal with the application of *ratione personae* and *ratione materiae* of close-out netting. However, contrary to what the text seems to suggest, there is **no international consensus that this field of application should be the broadest possible**. In fact, several

domestic collective insolvency regimes aim at enabling the debtor to recover rather than serving only the creditors' interests. Such regimes prohibit or subject the exercise of close-out netting provisions after the commencement of collective insolvency proceedings to certain conditions. This objective can also be found in some international work on crisis resolution measures which advocate the possibility for the resolution authorities to suspend close-out netting provisions if resolution proceedings are commenced (see below).

7. Close-out netting provisions, derogating as they do from ordinary law, in particular the law applicable to collective insolvency proceedings which establishes a principle of equality of creditors in collective proceedings, are only **justified to the extent that there is systemic risk**. This entails two important consequences:

– the definition of "eligible party" should be **limited to counterparties capable of being a source of systemic risk in the light of the magnitude of their obligations**, that is, to financial counterparties and larger commercial undertakings. Other counterparties (less important undertakings, and natural persons, for example) which are not capable of being a source of systemic risk should be excluded;

– the definition of "eligible obligation" should be **limited to contracts capable of creating a high counterparty risk, and therefore systemic risk**. Otherwise, creditors not in need of special protection could net contracts that are not a source of systemic risk; they would thus benefit from an undue advantage in the collective proceedings vis-à-vis other creditors and possibly risk compromising the objective of the proceedings.

8. At the very least, the draft should, on the one hand, accommodate **the possibility for States to limit** the definition of eligible parties and obligations, rather than the possibility of including any other person or any other type of contract designated to that effect as an eligible party under the law of the State, as is currently being proposed. On the other hand, the text should offer the possibility for States to take into account the concerns expressed at international level as to the risks and adverse consequences that may result from the operation of close-out netting provisions in collective insolvency or resolution proceedings.

Remarks on Principles 7 "Enforceability of close-out netting" and 8 "Exception in respect of resolution of financial institutions"

9. These two Principles should be thoroughly reviewed. They are based on the premise that a close-out netting provision **should always be enforced in accordance with the agreement of the parties to the detriment of the law of the place where insolvency proceedings of the defaulting party are opened (lex concursus)** and which might impede enforcement. This premise is far from obvious.

10. Generally, as is demonstrated by a number of international initiatives [1] on this topic, it is essential to **accommodate the powers of the resolution authorities in managing bank crises**. The competent authorities should have the power, in certain cases, to **suspend close-out netting provisions** so as to prevent their enforcement hindering the authorities in exercising their resolution powers, increasing market instability by blocking numerous open transactions, and definitely reducing the chances of successfully preserving the institution in distress. Both the Dodd-Frank Act and the future EU Bank crisis management directive contemplate the suspension of close-out netting provisions in case of proceedings opened in the context of resolution measures. It is therefore important for Principle 7 to provide that it applies "without prejudice to the exception provided for in Article 8". Moreover, draft Principle 8, paragraph 2 should be clarified.

[1] In particular, the work carried out by the FSB ("Key Attributes of Effective Resolution Regimes for Financial Institutions", of the CPSS/IOSCO draft report on "Recovery and Resolution of Financial Market Infrastructures", and the CPSS/IOSCO "Principles for financial market infrastructures".

Principle 9 "Governing law of close-out netting provisions"

11. Paragraph 1 provides that the **law applicable to the validity and effectiveness of a close-out netting provision** is the law chosen by the parties (*lex contractus*): therefore it completely excludes the application of the law of the place where the insolvency proceedings were opened (*lex concursus*) to the validity and enforcement of a close-out netting provision. This rule is much too broad, and should be limited to undertakings that represent a systemic risk. The same applies to paragraph 2, which provides that the **law applicable to determining which contracts** are eligible for being covered by a close-out netting provision is the law chosen by the parties in their agreement.

12. Draft Principle 9 should be completed so as also to provide a **subsidiary connecting factor** (in the event of the parties to the close-out netting provision not having chosen the applicable law, either expressly or tacitly), as is usually the case of conflicts of law rules.